

# Selected Opinions Volume XXI

From July 1, 2015 to June 30, 2016



Compiled by Technical Services Directorate  
*The Institute of Chartered Accountants of Pakistan*

## **INTRODUCTION**

This report is the nineteenth compilation of selected opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from **July 2015 to June 2016** for the general guidance of the members of the Institute.

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

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

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

### **Directorate of Technical Services**

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## 1.1 APPLICATION OF IAS 39 TO DIRECTORS' INTEREST FREE LOANS

**Enquiry:** Our attention was drawn to section 2.3 “Key Findings” of the QAB report 2014 where it has been reported in paragraph 2.3.1 (reproduced below ) that the deficiency in respect of interest free long term loans from related parties (Directors & Shareholders) due to non-application of IAS 39 with respect to discounting of the loan amount at assumed market rate for the assumed period of repayment which according to the interpretation of the directorate is mandatory under IAS 39.

### “2.3.1 Application of IAS 39 ‘Financial Instruments: Recognition and Measurement

Deficiencies in initial recognition and subsequent measurement of interest free long term loans and liabilities were noted in number of audit engagements reviewed during the period.

It was observed that interest free long term loans and liabilities, most of them from related parties, were recognized initially at the loan amount received as against the fair value of the loan amount and were not subsequently carried at their amortized cost using effective interest method. Most of the audit engagement partners were of the opinion that these are interest free loans with no agreed repayment terms or defined maturity; therefore it was difficult for management to estimate future cash flows and calculate effective interest rate of the loan.

The QAB would like to draw attention to requirements of IAS 1 “Presentation of Financial Statements” which requires that the liabilities can be classified as non-current only in specific circumstances. One of the requirements is for the entity to have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Accordingly, all liabilities with no agreed repayment terms or defined maturity are to be considered as due on demand and should be classified as current.

Whereas in respect of loans and liabilities where the entity has agreed with the lenders not to demand repayment for a particular period (in excess of twelve months after the reporting period) should be discounted over the agreed period.”

It may please be noted that the aforesaid QAD’s finding has been reported without giving full facts about the nature of the loans and is based upon highly inappropriate, debatable reasoning and arbitrary interpretation of IAS-39. May be for this reason it has been given in very vague wording without quoting any relevant paragraphs of the said IAS because of the misapplication of the said standard.

The entire confusion is because it has been assumed that the ‘Directors and Shareholders Loans which are interest free and are payable at the discretion/convenience of the company are financial instruments and on this wrong assumption IAS 39 ‘Financial Instruments: Recognition and Measurement’ has been applied.

**Definition of ‘Financial Instrument’ and ‘Financial liability’ are given in** Paragraph 11 of IAS 32 which is reproduced below for ready reference and for better understanding of the concept:

“A ‘financial instrument’ is any **contract** that gives rise to a financial asset of one entity and financial liability or equity instrument of another entity.

A '**financial liability**' is any liability that is:

- (a) a contractual obligation:
  - (i) to deliver cash or another financial asset to another entity; or
  - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) a contract that will or may be settled in the entity's own equity instruments and is:
  - (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes true entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipts or delivery of the entity's own equity instruments."

If we put to test "Directors Interest Free Loans payable at the discretion/ convenience of the company" against the definitions of given above it would be observed that:

- There is no contract.
- There is no commitment to pay as it is payable at the discretion/convenience of the company – Loan is a sort of "Qaraz e Hassna".
- There is no commitment to settle the loan in exchange of any financial assets or financial liabilities under conditions that are potentially unfavourable to the entity
- There is no commitment to settle this loan with the equity instruments of the entity.

I would also like to draw your kind attention to the definition of 'contract' given in the Contract Act (1872) applicable in Pakistan which is reproduced below:

An agreement enforceable by law is a **contract**; and every promise and every set of promises, forming the **consideration** for each other, is an agreement.

On the basis of aforementioned definition, the essentials of a (valid) contract are:

- (a) **Intention to create a contract;**
- (b) Offer and acceptance;
- (c) **Consideration;**
- (d) Capacity to enter into a contract;
- (e) Free consent of the parties;
- (f) Lawful object of the agreement;

In the case of the directors loans mentioned above two very important ingredients required for a valid contract that is “**intention to create a contract**” and “**consideration**” are missing and hence there is no contract.

From the explanations given in the aforementioned paragraphs, it is abundantly clear that liability in respect of “Directors Interest Free Loans payable at the discretion/convenience of the company” is merely a “**Qaraz e Hassna**” and is not a financial liability as defined in IAS 32 and hence IAS 39 – ‘**Financial Instruments: Recognition and Measurement**’ is not applicable under the circumstances.

Therefore, this liability to the Directors would be disclosed on the face of the balance sheet without amortisation as non-current liability like ‘liability for deferred tax’ or other liabilities which are not termed as “financial liability”.

IAS-39 was first issued in March 1999 and since then has been considered as one of the most complex and controversial standards ever issued by IAS Board. In view of the complexity this standard has been revised numerous times since then and in many countries in the world has still not been implemented. Even in Pakistan the financial institutions (i.e. banks, insurance companies etc.) which are most resourceful with respect to technical support have not been obliged to enforce it due to lot of contagious issues. It is therefore suggested that one should avoid unnecessary innovative interpretations of the standards related to financial instruments, particularly when in fact there is no actual or legal financial impact.

Moreover Pakistan is an Islamic Country and under the constitution it is obliged to follow the principles of Islam and anything which is in conflict is against the Constitution. Therefore forcing some-one to take interest against his will, even if it is called “notional interest” is against Islam and the Constitution of Pakistan. ICAP realises this and has therefore constituted a committee to make Sharia Compliant Islamic Accounting Standards which are being implemented through SECP.

The Committee is requested to consider the matter and to resolve existing and future controversies in the best interest of the ICAP, members, profession and industry.

**Opinion:** The Committee considered your enquiry and would like to draw your attention to the following paragraphs of IAS 32 ‘*Financial Instruments: Presentation*’:

- 11 *A **financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.*

*A **financial liability** is any liability that is:*

- (a) a contractual obligation*  
*(i) to deliver cash or another financial asset to another entity; or*  
*(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or*  
*(b) a contract that will or may be settled in the entity’s own equity instruments.....*

- 19 *If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D. For example:*

- (a) a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment*

*from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.*

*(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.*

20 *A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions.....*

A financial instrument will be a financial liability, where it contains an obligation to repay. Para 47 of IAS 39 'Financial Instruments: Recognition and Measurement' recognises two classes of financial liabilities:

- Financial liabilities at fair value through profit or loss
- Other financial liabilities measured at amortised cost using the effective interest method.

Some of the examples of financial liabilities are trade payables, loans from other entities, and debt instruments issued by the entity. IAS 39 requires recognition of a financial asset or a financial liability when, and only when, the entity becomes a party to the contractual provisions of the instrument [IAS 39.14]. Following relevant features need to be considered when classifying a financial instrument as liability:

- The instrument is a liability if the issuer can or will be forced to redeem the instrument.
- The instrument is a liability if the choice of settling a financial instrument in cash or otherwise is contingent on the outcome of circumstances beyond the control of both the issuer and the holder, as the issuer does not have an unconditional right to avoid settlement.
- An instrument is a liability if it includes an option for the holder to put the rights inherent in that instrument back to the issuer for cash or another financial instrument.

AG64 and AG65 of IAS 39 give recognition of interest free long-term loan. Interest free loans or below-market rate of interest are commonly made between entities in a group on a non-arm's length terms and/or made with no stated date for repayment. The fair value of such loans is not usually the same as the loan amount, and IAS 39 requires both parties to initially record the liability at fair value.

Where intercompany loans are made on normal commercial terms, no specific accounting issues arise and the fair value at inception will usually equal the loan amount. However, where the loan is not on normal commercial terms that is interest free, the required accounting depends on the terms, conditions and circumstances of the loan. It is therefore necessary to ascertain the terms and conditions, which may not be immediately apparent if the loan documentation is not comprehensive.

The Committee understands that the Contract Act, 1872 at its own does not specifically require a contract to be in writing and nowhere mentions that any unwritten agreement will not be enforceable under law and deemed as a contract. Due to this, verbal and implied agreements create contractual obligations. It is pertinent to note that IAS 32 also does not put a condition that contractual obligation must be evidenced by a written or registered contract.

The above is also supported from statutory requirements contained in Sections 196, 214 to 216, and 218 to 219 of the Companies Ordinance, 1984 (the Ordinance) in case loan is borrowed from a director. Discussion of proposed loan/ borrowing in the board's meeting, due deliberations regarding objectives and usability of such loan / borrowing and the resolution passed by the Board to approve such loan / borrowing also establishes the contractual obligations. Though many times, repayment terms and conditions are not defined but at one point or the other these would be defined and it does not change the substance as well the legal form of the transaction. It is important to note that where no repayment period is defined and loan is dependent on the entity's ability to repay (or payable on demand) it becomes current liability of the borrower.

The Committee believes that the directors' interest in the entity is the consideration of loan. The director gives interest free loan to the company with the intention to support or improve the liquidity position of the company or as share deposit. In future, when the company's financial position improves, the director ultimately earns the return in the form of good dividend or capital gain. So the intent and consideration elements both exist, therefore, the Committee does not agree with your views that these two elements of contract as defined in Contract Act are missing.

With regard to your views that directors interest free loans payable at the discretion/convenience of the company is a "Qaraz e Hassna", the Committee is of the view that the term "Qaraz" in itself reflect liability of the borrower and "Qaraz e Hasana" also reflects intention of lender to recover subject to ability of borrower to repay. The existence of contract to borrow and repay is reflected by entity's own actions where the company records the sum obtained as liability and if that is not correct the person giving the sum can correct that mistake and then such sum given and obtained would become grant.

The classification of liabilities is covered in para 69 of IAS 1 which requires that a liability should be classified as current and one of the conditions for classification as current include when the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. The comment in the QAB annual report related to classification of liabilities with uncertain repayment terms and was based on the guidance given in IAS 1. The comment in the QAB report did not require use of any assumed market rate or assumed period of repayment.

Based on above, the Committee is of the view that loans including inter-company interest free loans meet the definition of financial instruments and come within the scope of IAS 39 and also establishes binding contract between a director and company.

(July 01, 2015)

## 1.2. CLARIFICATION ON DEFERRED TAX RATE

**Enquiry:** Through the Finance Act, 2015 the rate of tax for companies have been reduced to 32% for 2015-2016, 31% for 2016-2017 and 30% for 2017-2018 and onward.

Keeping in view the requirements of IAS 12 "Income Taxes" and also the recommendation of committees (published in selected opinions dated 10 September 2014) our understanding is that to determine the deferred tax liability of the company as on 30 June 2015 the tax rate of 32% will apply for the temporary differences that will be reversing in the year 2016 and 31% will apply on temporary differences that will be reversing in 2017 and 30% on the temporary differences that will be reversing in 2018 and onward.

On practical grounds it seems impossible for a company to determine (as on 30 June 2015) that how much temporary differences will be reversing in year 2016, 2017 and 2018 onwards because there are many variables that are not predictable are involved to determine the value of these temporary differences.

Please guide us how a company that is preparing its financial statements in accordance with IASs can comply with the requirements of IAS 12 and how the deferred tax liability can be calculated?

**Opinion:** The Committee would like to draw your attention to the following paragraphs of IAS 12 'Income Taxes':

15 A deferred tax liability shall be recognized for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

(a) the initial recognition of goodwill; or



- (b) 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).

47 Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

51 The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

51A In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:

- a. the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
- b. the tax base of the asset (liability).

In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

IAS 12 states that deferred tax assets and liabilities should be measured based on the tax rates that are expected to apply when the asset/liability will be realised/ settled.

Illustrative Example (IE) No. 2 that accompanies to IAS 12 shows detailed calculation of deferred tax assets and liabilities and illustrative disclosure of its major components.

The Committee is of the view that the ICAP opinion you referred to in your query is self-explanatory and does not need further clarification on the matter.

(August 11, 2015)

### 1.3 CLARIFICATION ON AMORTIZATION OF DIRECTOR'S LOAN

**Enquiry:** As per IAS 39 Para 39, limited companies have to amortize the director loan over a period of repayment thereof. Please note that most of our client's director's loan repayment period is undeterminable. The loans are interest free. Additionally the clients are also not ready to amortize their loan from directors.

This will attract income tax. Some of the loans are subordinated with banks. The loans are given by the sponsors /directors to tide over the liquidity position of the company. Banks are not ready to advance such loan.

We are facing the following limitation in accruing the director's loan.

1. Company is not able to repay the loan
2. Client income will be liable to income tax.
3. Disclosure of repayment as per ISA 39 Para 9 will have significant impact on Financial Statement.

Please advise on the following:

1. What steps should we take if the client refuses to amortize the directors/sponsors loan?
2. What time period does amortization of the directors loan needs to be carried out?
3. Please guide how the amount should be disclosed in the accounts when the loan relates to more than 10 years and payable when able. In actual fact it is not repayable by the company.
4. Under the Companies Ordinance, 1984 company can't hold share application money for indefinite period.

**Opinion:** The Committee would like to draw your attention to the following paragraphs of IAS 32 '*Financial Instruments: Presentation*':

- 11     **A financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

**A financial liability** is any liability that is:

- (a) a contractual obligation
- (i) to deliver cash or another financial asset to another entity; or
  - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) a contract that will or may be settled in the entity's own equity instruments.....

- 19     If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D. For example:

(a) a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

- 20     A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions.....

A financial instrument will be a financial liability, where it contains an obligation to repay. Para 47 of IAS 39 '*Financial Instruments: Recognition and Measurement*' recognises two classes of financial liabilities:

1. Financial liabilities at fair value through profit or loss
2. Other financial liabilities measured at amortised cost using the effective interest method.

Loans are within the scope of IAS 39 and complications arise if they are not on arm's length terms. Loans/ advances to or from related parties fall under the definition of financial instruments and are required to be dealt with as per the requirements of paragraphs 45 to 47 and AG64 to AG66 of IAS 39. IAS 39 requires recognition of a financial asset or a financial liability when, and only when, the entity becomes a party to the contractual provisions of the instrument (IAS 39.14).

AG64 and AG65 of IAS 39 give recognition of interest free long-term loan. Interest free loans are commonly made between entities in a group or a loan given by directors to company on a non-arm's

length terms and/ or made with no stated date for repayment. In this case, the required accounting depends on the terms, conditions and circumstances of the loan. It is therefore necessary to ascertain the terms and conditions, which may not be immediately apparent if the loan documentation is not comprehensive. It is pertinent to note that IAS 32 also does not put a condition that contractual obligation must be evidenced by a written or registered contract.

Inter-company loans also meet the definition of related party transactions in IAS 24.9 and the disclosures required by IAS 24.12-22 must be given in sufficient detail to enable the effect of the loans on the financial statements to be understood. Where there are significant uncertainties, such as the expected terms of a loan, the disclosures should refer to this.

The Committee understands that many times repayment terms and conditions are not defined but at one point or the other these would be defined and it does not change the substance as well as the legal form of the transaction. It is important to note that where no repayment period is defined and loan is dependent on the entity's ability to repay (or payable on demand) it becomes current liability of the borrower. In such cases, it will be necessary for management to determine the appropriate accounting based on the expected timing of repayments.

Para 69 of IAS 1 explains the classification of liabilities which requires that a liability should be classified as current and one of the conditions for classification as current include when the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.

However, if the loan is of long term nature then there should be a loan covenant and in that case, the loan will be stated at amortized cost in accordance with the requirements of IAS 39.

With regard to your specific queries, the Committee response is as follows:

1. The auditor's opinion whether or not to qualify audit report will be based upon the evidence obtained during the audit. The Committee is of the view that if the client refuses to amortize the director's loan then the auditor will have to analyze the evidences obtained and should form an appropriate opinion considering the compliance of respective IFRSs and the requirements of ISAs.
2. It depends on repayment terms and conditions of loan. If there is no repayment term then loan should be classified as short term.
3. When the loan relates to more than 10 years and it is certain that company will be unable to pay it or repayment is indeterminable then it would be classified as a liability.
4. For share deposit money, the Committee would like to refer its Selected Opinion No. 1.4 of Volume XVI on 'clarification on share deposit money' which addresses your issue.

(August 21, 2015)

#### 1.4 TECHNICAL OPINION ON ACCOUNTING FOR INVESTMENTS OF PROVIDENT FUND TRUST

**Enquiry:** Trust Deed and the Trust Rules made there-under are the constitutive documents of a Provident Fund Trust. These constitutive documents also spell out the accounting/ financial reporting and book keeping requirements of the Provident Fund Trust.

Financial statements of Provident Fund Trust are prepared in accordance with IAS 26 'Accounting and Reporting by Retirement Benefit Plans'. IAS 26 mandate valuation of investments of the Provident Fund Trust at fair value.

In case of some Provident Fund Trusts, the financial reporting provisions contained in the Trust Deed or the Trust Rules made there-under require that: a percentage of surplus arising on re-measurement of investments to fair value should not be appropriated among Provident Fund Trust Members; or a particular type of investment should be measured at cost; or a particular type of investment be measured at lower of fair value and cost etc.

Trustees of the Provident Fund Trust include such requirements in the Trust Deed the Trust Rules made there-under in view of prudence concept and to counter the demerits of fair value accounting of investments and in some cases to maximize the returns to Provident Fund Trust members

As the Trust Deed and the Trust Rules made there-under are the constitutive documents of a Provident Fund Trust, hence have an overriding effect on requirements of IAS 26. Please confirm this understanding.

Strength is also derived from the financial statements of open end mutual funds. In case of open end mutual funds, Trust Deed is the constitutive document and it is mentioned therein to amortize the preliminary expenses and flotation costs over a period of five years. Hence, requirements of constitutive document have an overriding effect on approved accounting standards. Accounting policy of "Preliminary expenses and flotation costs" and "Statement of compliance" of an open end mutual fund is reproduced below for ready reference:

"Preliminary expenses and floatation costs:

Preliminary expenses and floatation costs represent expenditure incurred prior to the commencement of operations of the Fund. These costs are being amortized over a period of five years commencing from \_\_\_\_\_, as per the requirement of the Trust Deed of the Fund."

"Statement of compliance

These financial statements have been prepared in accordance with approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 1984, the requirements of the Trust Deed, the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (the NBFC Rules), the requirements of the Non-Banking Finance Companies and Notified Entities Regulations, 2008 (the NBFC Regulations) and the directives issued by the Securities and Exchange Commission of Pakistan (SECP). Wherever the requirements of the Trust Deed, the NBFC Rules, the NBFC Regulations or the directives issued by SECP differ with the requirements of IFRSs, the requirements of the Trust Deed, the NBFC Rules, the NBFC Regulations or the directives issued by SECP prevail."

**Opinion:** The retirement benefit funds are established under the Trust Act, 1882 as separate entities in Pakistan and the trust deed is the incorporation document under which trust rules are formulated. The Trust Act, 1882 and the trust deed of the retirement benefit fund both require the preparation of financial statements for the funds but do not specify the applicable financial reporting framework under which the financial statements of the funds are required to be prepared. The generally accepted accounting framework in Pakistan is IAS/IFRS and for companies the requirement is emanating from section 234 of the Companies Ordinance 1984.

The accounts in Pakistan are required to be prepared in accordance with generally applicable framework so that they are comparable and understandable by the users. If the accounts are prepared in accordance with trust deed of each fund then they would not remain comparable. Trust deed can guide as to what is to be or not to be distributed but cannot override accounting policies which are required to be followed in accordance with IAS/IFRS. Hence, in view of the Committee IAS 26 will be the accounting framework of provident funds.

## 1.5 ACCOUNTING TREATMENT OF ACCRUED MARKUP LIABILITY

**Enquiry:** A company has got rescheduled its bank loan where the bank has agreed to waive off accrued markup subject to fulfillment of all the terms and conditions of the new agreement. The new loan is repayable up till 2021.

Your suggestion is required in respect of following:

- 1) Can company reverse the full amount of its accrued markup liability to income?
- 2) Can company reverse accrued markup proportionately to the extent repayment is made in each year?
- 3) Whether this income would require provision for tax?

If above is not suggested:

- 1) Can company revise its accrued markup liability to fair value by using company's average borrowing rate by taking the difference in P&L as income?
- 2) Whether this notional income would require provision for tax?
- 3) If company take accrued markup liability at fair value, should company also amortize this difference over number of years of agreement by debiting P&L and crediting liability.

**Opinion:** The Committee considered your enquiry and would like to draw your attention to following paragraphs of **IAS 39 'Financial Instrument: Recognition and Measurement'** (Volume 2009) which are self-explanatory:

40 An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

AG62 For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

Keeping in view of above, if the terms are substantially different, the modification of terms will be accounted for as an extinguishment. If the difference between discounted present value of the cash flows under the new terms old and new terms is more than ten percent the difference will be recognized in profit & loss account.

With regard to tax implication, the Committee is of the view that if tax benefit has been taken earlier on interest expense, the reversal of accrued markup would require the provision for tax.

## 1.6 DEFERRED TAX CLARIFICATION

**Enquiry:** Proposition is:

“How the concept of deferred tax shall apply to tax laws in Pakistan i.e. deferred tax vis-à-vis Section 113 of Income Tax Ordinance (Minimum tax on turn over). It is assumed that company always pays tax u/s 113.”

1. The spirit of IAS-12 Deferred tax is that every year should bear the burden of tax which is fairly attributable to it.
2. Example below shows that machinery is purchased in year 1 which claims initial allowance. Accounting profits are higher and tax profits are lesser therefore year 1 pays lower tax while year 2 and subsequent years pay higher tax. There will be a deferred tax liability in year 1.

This will happen if tax is calculated as percentage of tax profit

### EXAMPLE

A company (Pvt) Ltd.

Year	1	2
Turnover	300 M	300 M
Profit before dep.	8 M	8 M
Machinery purchased	2 M	-
Initial allowance	25 %	-
Depreciation	10 %	10 %
Rate of Tax	33 %	33 %
Minimum tax (of turn over)	1 %	1 %

### PROFIT & LOSS ACCOUNT

Year	A/c Profit	1 Tax Profit	A/c.	2 Tax
Turnover	300 M	300 M	300 M	300 M
Profit (before dep.)	8,000,000	8,000,000	8,000,000	8,000,000
Less Dep.				
Initial allowance	-	500,000	-	-
Depreciation	<u>200,000</u>	<u>150,000</u>	<u>180,000</u>	<u>135,000</u>
	200,000	650,000	180,000	135,000
Net Profit	<u>7,800,000</u>	<u>7,350,000</u>	<u>7,820,000</u>	<u>7,865,000</u>
Tax @ 33%	2,574,000	2,425,500	2,580,600	2,595,450
Deferred tax calculations:				
Normal tax		2,425,500	2,595,450	
Deferred tax (Liability)		148,500	(14,850)	
(2574000 – 2425500)				

Total Tax	2,574,000	2,580,600
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Deferred tax liability of Rs. 148,500 will be created and carried over to subsequent years and will be adjusted.

### **TAX LAW IN PAKISTAN**

Tax liability is Rs. 2,425,500 and deferred tax Rs. 148,500 while calculating tax as percentage of tax profit.

**Tax liability @ 1% of turnover is Rs. 3,000,000/-** and actual payment is Rs.3,000,000/-

Company is paying higher tax.

- (i) Can there be any deferred tax? (Liability or assets) If so, how much??
- (ii) Is there any temporary difference?

### **SECOND EXAMPLE**

If fixed assets are revalued, does it give rise to any deferred tax (liability or assets)? Whereas tax laws in Pakistan does not recognize any revaluation and calculates depreciation on cost (reducing balance).

Let me make the second example more explicit.

Year 3

Fixed Asset – Machinery is re-valued on 1<sup>st</sup> July to Rs. 3.000 million

	Accounting	Tax
Sales	300,000,000	300,000,000
	=====	=====
Profit	8,000,000	8,000,000
Dep.	300,000	121,500
	=====	=====
Net Profit	7,700,000	7,878,500
Income tax 33%	2,541,000	2,599,905
Sec. 113 – tax	3,000,000	3,000,000

Actual payment of tax is Rs. 3,000,000. Our tax law does not recognize the revaluation of fixed asset. Depreciation is calculated on written down value (initial allowance + dep.). What is the deferred tax?

My understanding is that deferred tax comes into play only and only if tax is calculated as percentage of income. If Sec.113 applies throughout there cannot be any deferred tax (liability or asset). We have to look at the things in the light of our income tax law.

Fixed Asset Schedule

1 <sup>st</sup> Year	Accounting	Tax
Cost	2,000,000	2,000,000



Initial allowance 25%	-	500,000
Depreciation 10%	<u>200,000</u>	<u>150,000</u>
	200,000	650,000
	=====	=====
W.D. Value	1,800,000	1,350,000
2 <sup>nd</sup> Year		
Depreciation 10%	<u>180,000</u>	<u>135,000</u>
W.D. Value	<u>1,620,000</u>	<u>1,215,000</u>
	=====	=====
3 <sup>rd</sup> Year		
Machinery revalued	3,000,000	1,215,000
Depreciation 10%	<u>300,000</u>	<u>121,500</u>
	<u>2,700,000</u>	<u>1,093,500</u>
	=====	=====

**Opinion:** The Committee would like to draw your attention to the following paragraphs of IAS 12 'Income Taxes' (underline is ours):

**'Current tax'** is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

**'Taxable profit (tax loss)'** is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

- 15 A **deferred tax liability** shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:
- (a) the initial recognition of goodwill; or
  - (b) 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).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39.

- 16 It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39 (underline is ours).
- 24 A **deferred tax asset** shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:



- (a) is not a business combination; and
- (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.

Following paragraphs of ICAP's Technical Release (TR – 27) 'IAS-12, *Income Taxes (Revised 2000)*' also supports this fact:

- 3.1 *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. (underline is ours)*
- 3.3 *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.*

Based on above, the Committee is of the view that calculation and accounting of deferred tax is required when an entity is paying tax under Section 113 of the Income Tax Ordinance, both in the case of temporary differences arising from accelerated depreciation and revaluation of fixed assets.

However, your attention is also drawn to para 24 (reproduced above) and para 27 & 28 of IAS 12:

- 27 *The reversal of deductible temporary differences results in deductions in determining taxable profits of future periods. However, economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.*
- 28 *It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:*
  - (a) *in the same period as the expected reversal of the deductible temporary difference; or*
  - (b) *in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.*

*In such circumstances, the deferred tax asset is recognised in the period in which the deductible temporary differences arise*

Keeping in view the above, the Committee is of the view that deferred tax assets will only be recognised when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised. Therefore, in Committee's opinion deferred tax should be recognized to the extent of deferred tax liability recognized on taxable temporary differences and for any additional recognition of deferred tax asset the conditions as laid down in para 24 of IAS 12 as reproduced above should be satisfied.

The Committee would also like to refer its previous Selected Opinions No 1.13 of Volume 19 'Deferred Tax' and Selected Opinion No. 1.9 of Volume 16 'Deferred tax - revaluation surplus on building' for your guidance which addresses your issues.

(December 02, 2015)

## 1.7 TECHNICAL ADVICE ON DEFERRED TAXATION ON INVESTMENTS IN SUBSIDIARIES, BRANCHES AND ASSOCIATES AND INTERESTS IN JOINT ARRANGEMENTS

**Enquiry:** We are a non-quoted public company and we seek your guidance regarding recognition of deferred tax asset / liability.

We have made long term investments in our associated companies (non-quoted), having same board of directors and shareholding. The income of investor and investee Company, both is taxable under section 169 of the Income Tax Ordinance 2001. The company has been recognising re-measurement gain on long term investments through equity method.

Now the auditors are of the view that we should provide deferred tax liability on these gains.

As per para 38 and 39 of the IAS 12:

### **Investments in subsidiaries, branches and associates and interests in joint arrangements**

38 Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint arrangements (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest. Such differences may arise in a number of different circumstances, for example:

- (a) the existence of undistributed profits of subsidiaries, branches, associates and joint arrangements;
- (b) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and
- (c) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

39 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:

- (a) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and
- (b) it is probable that the temporary difference will not reverse in the foreseeable future.

We are of the view that we met both the conditions of para 39 and we don't foresee that these differences will reverse in future, so we need not to provide the deferred tax liability.

Further, the guidance available in ICAP selected opinions (17.1.02) suggests that no deferred taxation is to be recognised, when the temporary differences are not expected to reverse in future. Moreover, many listed companies like Nishat Mills Limited, Fuji Fertilizer Company Limited, Mahmood Textile Mills Limited etc. has not provided deferred taxation liability for long term investment in associates. Kindly give your advice on the issue.

**Opinion:** The Committee would like to draw your attention to para 38, 39 (reproduced above), 42, 51 and 51A of IAS 12 for guidance:

- 42 An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.
- 51 The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.
- 51A In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:
- a. the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
  - b. the tax base of the asset (liability).

In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

The Committee is of the view that as stated in para 42, an investor in an associate does not control the investee entity and is usually not in a position to determine its dividend policy. Therefore, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate, unless there is an agreement requiring that the profits of the associate will not be distributed in the foreseeable future. Further, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement, in accordance with para 51A of IAS 12.

(January 01, 2016)

## 1.8 IFRS 10 EXEMPTION FROM CONSOLIDATION

**Enquiry:** Paragraph 4(a) of IFRS 10 - "Consolidated Financial Statements" - allows that an entity with subsidiaries need not present consolidated financial statements, if a number of detailed conditions are met. The aforesaid paragraph of IFRS 10 is as follows:

*"a parent need not present consolidated financial statements if it meets all the following conditions:*

- i. it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;*
- ii. its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);*
- iii. it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and*
- iv. its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs."*

How should the requirement that the entity's parent produces financial statements that "comply with IFRSs" be interpreted? Does it mean that the criteria in IFRS 10.4(a) are only met, if the entity's parent produces financial statements that comply "as-is" with IFRSs as issued by the IASs? Is the condition (iv) above considered to be met in the local environment when an explicit and unreserved statement of compliance with IFRSs is not made in the financial statements locally?

**Opinion:** With reference to your query relating to interpretation of para 4(a)(iv) that qualifying for the exemption, the reporting entity should be compliant of full IFRS; the Committee is of the view that since while adopting IFRS 10 in Pakistan, no modification to the requirement of compliance with IFRS for the consolidated financial statements of the parent was made, therefore the exemption is only available when the parent prepares IFRS compliant financial statements having an explicit and unreserved statement of compliance with IFRSs.

Further the Committee would like to draw your attention to the requirements of Section 237 of the Companies Ordinance 1984 reproduced below: (underline is ours)

**237. Consolidated financial statements.** - (1) There shall be attached to the financial statements of a holding company having a subsidiary or subsidiaries, at the end of the financial year at which the holding company's financial statements are made out, consolidated financial statements of the group presented as those of a single enterprise and such consolidated financial statements shall comply with the disclosure requirement of the Fourth Schedule and an International Accounting Standards notified under sub-section (3) of section 234.

(January 04, 2016)

## 1.9 TECHNICAL OPINION ON IAS 26

**Enquiry:** Our Company is maintaining separate funded Gratuity and Pension Funds (defined benefit plans) for the provision of retirement benefits to its eligible employees. Annual actuarial valuations are carried out for the determination of the liability to be recorded in the Company's financial statements as of year-end as per IAS 19. The defined benefit liability recognized in the financial statements of the Company for the above defined benefit plans, as per the requirement of IAS 19, is the net total of the present value of defined benefit obligation at the end of the reporting period and current service cost minus the fair value of plan assets at the end of the said reporting period.

The following example would be helpful to explain the above fact and for discussions hereinafter:

	(Rupees)
Present value of defined benefit obligation as of the year end	300
Fair value of plan assets as of the year-end	(100)
Net liability at end of the year (as recognized in the financial statements of the company) / unpaid contributions (representing deficit in the Fund)	200

### Enquiry

The query is in respect of the preparation of the separate financial statements of defined benefit plans and not from the perspective of the Company.

The query is in respect of assets that can be recognized in the separate financial statements of the defined benefit plans under IAS 26 (Accounting and Reporting for Retirement benefit Plans), under which these financial statements are being prepared.

To be specific, can a defined benefit retirement plan record the above deficit of Rs. 200 in the Fund as an amount receivable from the Company in its separate financial statements under IAS 26 (as an asset)? In other words can it form part of the 'Net assets available for benefits' to be reported in the separate financial assets of a defined benefit plan?

### **Company's Viewpoint / Treatment**

We have been preparing our funds' financial statements on the convention that amount not yet contributed by the Company (amounting to Rs.200 in the above example) is booked as receivable from company in the 'Statement of Net Assets Available for Benefits' of the funds. This view is based on the fact that liability for the said amount has also been recognized by the Company in its own financial statements.

Furthermore previously our funds were being audited by one of the top audit firms for a period of six years and they maintained the same treatment. However our audit firm has been rotated for FY2015 and the incoming auditors are of the view that such amount should not be made part of 'Statement of Net Assets Available for Benefits' instead it should only be disclosed in the notes to financial statements. The detailed viewpoint of our existing auditors is given in following paragraphs

In view of the above, we are in disagreement with our existing auditors and request you for the advice in this regard at the earliest.

### **Auditors' Viewpoint / Treatment**

Existing auditor recommends that this amount of Rs.200, representing deficit in the fund, is not part of the 'Net Assets Available for Benefits' and as such cannot be so recorded as an amount receivable from the Company in the separate financial statements of the defined benefit plan for inclusion in the said net assets (although its separate disclosure is required as a deficit in the Fund).

As per the definition of 'Net assets available for benefits' given in IAS 26, the amount of deficit mentioned above do not form part of the 'Net assets available for benefits'. This fact can be corroborated from the definition itself wherein it indicates that net assets are the assets of the plan (net of liabilities mentioned therein). Plan assets have been explained in more detail in paragraph 114 of IAS 19, under which it states that the 'Plan Assets.' exclude unpaid contributions due from the reporting entity to the fund, and as such for this reason the view is that since no 'funding' has been made to the Fund by the Company, un-contributed amount cannot be considered part of the assets or 'Net Assets' of the Fund.

Paragraphs 17 and 28 of IAS 26 gives different formats for the presentation of actuarial information. In each of these formats, essentially the essence is the quantification / presentation of deficit / surplus and is determined by deducting the 'net assets available for benefits' with the actuarial present value of promised retirement benefits. In case the amount yet due from the Company (amounting to Rs.200 in the above mentioned example) is included in the net assets available for benefits' in the separate financial statements of the defined benefit plan, essentially there would no deficit or excess to quantify and report. These paragraphs essentially contain different modes of the presentation of net assets and actuarial obligation and at no point does it mention that the amount not yet contributed by the Company is part of the net assets available for benefits.

Essentially the view is that in case of both the Company and the separate financial statements of the defined benefit plan, fair value of the plan assets should be the same (i.e. Rs.100 in the above mentioned example) on the assumption that the Fund carries all of its assets at fair values.

Furthermore, since these are defined benefit plans, the obligation vests with the reporting entity (i.e. the Company) and as such an obligation cannot be created in the separate financial statements of the Fund for the present value of promised retirement benefits. Recognition of a balance receivable

from the Company in the said separate financial statements (in respect of the deficit / unpaid contributions) would amount to the recognition of the liability as explained above. Fund's responsibility is only the maintenance of the assets in accordance with its mandate.

We would appreciate ICAP's views and necessary clarification on the above-mentioned query.

**Opinion:** The Committee would like to draw your attention to the following paragraphs of IAS 26 'Accounting and Reporting for Retirement benefit Plans': (underline is ours)

***Net assets available for benefits*** are the assets of a plan less liabilities other than the actuarial present value of promised retirement benefits.

***Actuarial present value of promised retirement benefits*** is the present value of the expected payments by a retirement benefit plan to existing and past employees, attributable to the service already rendered.

17 The financial statements of a defined benefit plan shall contain either:

(a) a statement that shows:

- (i) the net assets available for benefits;
- (ii) the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; and
- (iii) the resulting excess or deficit; or

(b) a statement of net assets available for benefits including either:

- (i) a note disclosing the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; or
- (ii) a reference to this information in an accompanying actuarial report.

If an actuarial valuation has not been prepared at the date of the financial statements, the most recent valuation shall be used as a base and the date of the valuation disclosed.

#### **Financial statement content**

28 For defined benefit plans, information is presented in one of the following formats which reflect different practices in the disclosure and presentation of actuarial information:

(a) a statement is included in the financial statements that show the net assets available for benefits, the actuarial present value of promised retirement benefits, and the resulting excess or deficit. The financial statements of the plan also contain statements of changes in net assets available for benefits and changes in the actuarial present value of promised retirement benefits. The financial statements may be accompanied by a separate actuary's report supporting the actuarial present value of promised retirement benefits;

(b) financial statements that include a statement of net assets available for benefits and a statement of changes in net assets available for benefits.

The actuarial present value of promised retirement benefits is disclosed in a note to the statements. The financial statements may also be accompanied by a report from an actuary supporting the actuarial present value of promised retirement benefits; and

(c) financial statements that include a statement of net assets available for benefits and a statement of changes in net assets available for benefits with the actuarial present value of promised retirement benefits contained in a separate actuarial report.



In each format a trustees' report in the nature of a management or directors' report and an investment report may also accompany the financial statements.

Your attention is also drawn to following paragraph of IAS 26 'Accounting and Reporting for Retirement Benefit Plans':

- 31 This Standard accepts the views in favor of permitting disclosure of the information concerning promised retirement benefits in a separate actuarial report. It rejects arguments against the quantification of the actuarial present value of promised retirement benefits. Accordingly, the formats described in paragraph 28(a) and (b) are considered acceptable under this Standard, as is the format described in paragraph 28(c) so long as the financial statements contain a reference to, and are accompanied by, an actuarial report that includes the actuarial present value of promised retirement benefits.

From the above referred definitions and paragraphs, it implies that unpaid contributions due from the reporting entity to the fund are excluded from plan assets. Paragraph 17 and 28 explains different formats of presentation of net assets and actuarial obligation and does not anywhere mention that the amount not yet contributed by the Company is part of the net assets available for benefits.

Based on the above, the Committee is of the view that unpaid contributions cannot form part of the 'Net assets available for benefits' in the separate financial statements of a defined benefit plan and may be disclosed in the notes.

(January 11, 2016)

## 1.10 ACCOUNTING TREATMENT OF "WORKERS PROFIT PARTICIPATION FUND"

**Enquiry:** According to clause 5.2 of the license granted by OGRA to one of the biggest gas companies in Pakistan (the Company) read with clause 5.02 of World Bank loan agreement with the said gas company, and guaranteed by the Government of Pakistan, the OGRA shall determine an annual return of 17.5% of the average net current value of the licensee/ borrower's fixed assets in operation for a financial year. The GDS if not paid or short paid shall be recovered under section 3 of the Natural Gas (Development surcharge) Ordinance, 1967 read with rule 3 of the Natural Gas (Development Surcharge) Rules 1967.

The Director General Audit. Customs & Petroleum during audit of the Company' accounts for FY 2009-10 (Para 2.7) pointed out that "inclusion of Rs. xxx million on account Of Worker Profit Participation Fund (WPPF) in "other operating expenses" for calculation of Final Revenue Requirement by the Company was not an expense and required to be appropriated from the profit earned by the Company/ Licensee". The OGRA, however, admitted treatment of WPPF as an expense which caused short payment of GDS of Rs.xx million which is in line with the World Bank loan covenant 5.02 d (iv) and is reproduced below for reference purposes:

**Quote:**

"The term "total operating expenses" means all expenses related to operations. including administration, adequate maintenance, compulsory contributions to employee funds, taxes and payments in lieu of taxes such as development surcharges or other levies on gas revenues, and provision for depreciation on a straight-line basis at a rate of not less than 6% per annum of the average current gross value of the Borrower's fixed assets in operation, or other basis acceptable to the Bank, but excluding corporate income tax, interest and other charges on debt".

As per DAC directives of 05.08.2015, the matter was referred to Finance Division for seeking their opinion regarding the treatment of WPPF in the Revenue Requirement/ Accounts of the Company. In response, Finance Division stated that since the matter involves interpretation of accounting treatment, therefore, Ministry of Petroleum sought advice from ICAP on the accounting treatment of WPPF.

**Opinion:** The Institute's relevant Committee has deliberated the matter and the views/comments based on the review of the related documents provided by you are as follows:

1. Section 3(1)(b) of the Companies Profits (Workers Participation) Act, 1968 (the Act) requires every company to which the Scheme set out in Schedule to the Act applies pay subject to adjustments, if any, every year to the Workers' Participation Fund constituted under the Act five percent (5%) of its profits during such year. The expression 'Profits' is defined in section 2 (d) of the Act.

The payment of such amount to the Fund is then distributed to workers' of the company as per their respective entitlement provided under the Act and the left over amount from the allocation, if any, is paid into the treasury of the Government on account of Worker's Welfare Fund established under the Workers Welfare Fund Ordinance, 1971.

The Act accordingly requires that where there are workers' in a company the payment of 5% of profit is mandatory. The amount so calculated is deducted from the profit for the year of the company and after providing for taxation on profits and any other applicable item, net profit available to the owners of the company is arrived at. Distribution of such net profit after taxation for the year to the owners is taken as appropriation of profit.

2. Further, the Conceptual Framework of International Financial Reporting Standards (IFRS) issued by International Accounting Standards Board defines an expense as "Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants". As workers' are not the equity participants of the company, the amount towards Workers' Participation Fund is an expense in accordance with the requirements of IFRS.
3. With regard to the provisions of the World Bank Loan Agreement "the term '**total operating expenses**' means **all expenses related to operations**, including.....**but excluding corporate income tax, interest and other charges on debt**".

As explained above the payment towards Workers' Participation Fund is mandatorily required for the workers' of the company by the Act. We consider that the involvement and job of workers' in the company is towards operating activities of the company. Therefore amount payable to the benefit of workers' is an operating expenditure and all expenses related to operations are part of total operating expenses as provided in the meaning above. You would also note that the definition of total operating expenses in the agreement only excludes corporate income tax, interest and other charges on debt therefrom. Accordingly we agree with the determination of OGRA that payment to Workers' Participation Fund is an operating expense of the company.

Our above opinion is limited to the accounting treatment under the IFRS accounting framework and does not take into account other matters / documents concerning the issue under consideration of the Public Accounts Committee.

(April 05, 2016)

#### 1.11 QUERY ON TR - 32 'DIRECTOR'S LOAN'

**Enquiry:** An entity had a loan from directors amounting to Rs. 100 as at December 31, 2014. It was classified as long term loan and with repayable terms of 5 years and it was interest free. It was discounted using effective interest rate method, resultantly; difference between present value and cash received was made part of equity. The same treatment has been mentioned in TR 32 para 3.1.

##### Share Capital and Reserves

Equity Reserve 20



## Long term Loans

Loan from Directors 80

As on January 31, 2015 the terms were changed and it was decided that entity can pay the same on its own discretion and whenever they deem fit. **(the same treatment has been mentioned in Para 3.3 of TR 32)**

Now question is what will be the settlement accounting, whether I will only reclassify whole amount of 100 to equity or only reclassify 80. Whether there will be any consideration regarding restatement or no?

**Opinion:** The Committee considered your query and response to your queries are as follows:

- 1) Since Rs. 20 is already in equity as of Dec 31, 2014, therefore, on Jan 31, 2015, Rs. 80 should be further transferred to equity. The entity can report the full amount of Rs. 100 as equity contribution as a separate line item on balance sheet and in a separate column in statement of changes in equity and provide appropriate disclosure.
- (2) Restatement would not be appropriate because the terms of the loan changed after Dec 31, 2014.

(April 18, 2016)

## 1.12 QUERY ON GRATUITY

**Enquiry:** An industrial undertaking pays gratuity to the employee who completes one year of service equal to last month drawn salary and is not following strictly the provisions of law that employee is entitled to gratuity equal to last drawn salary x no. of years of service at the time he leaves the service.

### Further information

1. Accounting policy describes that gratuity is paid every year to the eligible person.
2. Gratuity paid every year is disclosed in the final accounts.
3. Employment agreement mentions that gratuity will be paid every year.
4. Employee has acknowledged the receipt of amount of gratuity.

### Please advise:

1. Under the circumstances, are the accounts misstated?
2. Is company liable to pay some amount to employee on account of gratuity who leaves the service say after 5 years while he has been receiving his gratuity every year in accordance with terms of employment?
3. How auditor should give his audit report in respect of gratuity? Or there is no need of mentioning anything?

Kindly give definite/specific answers, please do not reproduce the Standard.

**Opinion:** The Industrial & Commercial Employment (Standing Orders) Ordinance 1968 is applicable to all industrial and commercial establishments employing more than twenty workmen at any time during the preceding twelve months. For certain Standing Orders (S.O.) including the S.O. No. 12 (6) relating to termination of employment and payment of terminal benefits etc. the minimum number of persons employed is required to be 49 for Industrial undertakings and 20 for other undertakings. The relevant provisions of the S.O. No. 12 are reproduced below for reference:

### **12. Termination of employment.–**

- (1) *For terminating employment of a permanent workman, for any reason other than misconduct, one month's notice shall be given either by the employer or the workman. One month's wages calculated on the basis of average earned by the workman during the last three months shall be paid in lieu of notice.*
- (6) *Where a workman resigns from service or his services are terminated by the employer, for any reason other than misconduct, he shall, in addition to any other benefit to which he may be entitled under this Ordinance or in accordance with the terms of his employment or any custom, usage or any settlement or an award of a Labour Court under the [Punjab Industrial Relations Act 2010 (XIX of 2010)], be paid gratuity equivalent to [thirty days] wages, calculated on the basis of the [wages admissible to him in the last month of service if he is a fixed-rated workman or the highest pay drawn by him during the last twelve months if he is a piece-rated workman], for every completed year of service or any part thereof in excess of six months.*

*Provided that, where the employer has established a provident fund to which the workman is a contributor and the contribution of the employer to which is not less than the contribution made by the workman, no such gratuity shall be payable for the period during which such provident fund has been in existence.*

*Provided further that if through collective bargaining the employer offers and contributes to an "Approved Pension Fund" as defined in the Income Tax Ordinance, 2001 (XLIX of 2001), and where the contribution of the employer is not less than fifty per cent of the limit prescribed in the aforesaid Ordinance, and to which the workman is also a contributor for the remaining fifty per cent or less, no gratuity shall be payable for the period during which such contributions has been made.*

From the plain reading of the above two paragraphs it appears that gratuity under S.O. No.12 (6) (normally called **Statutory Gratuity**) is in addition to all other terminal benefits {except as mentioned in two provisos to S.O. No.12(6)} and can only be paid after termination of employment for any reason or resignation from service. The payment along with current pay does not, prima facie, seem to be aligned to the requirements of S.O. No.12 which deals with matters arising **on** and **after** the termination of the employment. You may interpret the inquired questions based on the above guidance provided by the Committee.

Further, considering that your query involves interpretation of the law, you are advised to seek legal opinion for more clarity and understanding.

(April 25, 2016)

### 1.13 QUERY ON CONSOLIDATION

**Enquiry:** SL needs your technical advice regarding existence of control over an associated company PL and consolidation of financial Statement.

Both the companies have common Chief Executive Officer (CEO). The information regarding the associated company is as below.

- (1) SL holds 49.24% shares of PL.
- (2) Number of directors on behalf of SL on the board of PL are three out of seven directors.

PL does not meet the definition of a subsidiary company for SL as per section 3 of the Company Ordinance 1984. Majority of the Directors are not representing SL, and the decisions are made by majority of the Board.

Your technical advice is sought, whether the accounts of SL will be consolidated with the accounts of PL (an unquoted Limited Company) for publication or SL will show its investment in PL on equity Basis.

**Opinion:** The Committee would like to draw your attention to the following paragraphs of **IFRS 10 'Consolidated Financial Statements'**:

6. 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.
  7. Thus, an investor controls an investee if and only if the investor has all the following:
    - (a) power over the investee (see paragraphs 10–14);
    - (b) exposure, or rights, to variable returns from its involvement with the investee (see paragraphs 15 and 16); and
    - (c) the ability to use its power over the investee to affect the amount of the investor's returns (see paragraphs 17 and 18).
- B18 In some circumstances it may be difficult to determine whether an investor's rights are sufficient to give it power over an investee. In such cases, to enable the assessment of power to be made, the investor shall consider evidence of whether it has the practical ability to direct the relevant activities unilaterally. Consideration is given, but is not limited, to the following, which, when considered together with its rights and the indicators in paragraphs B19 and B20, may provide evidence that the investor's rights are sufficient to give it power over the investee:
- (a) The investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities.
  - (b) The investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor.
  - (c) The investor can dominate either the nominations process for electing members of the investee's governing body or the obtaining of proxies from other holders of voting rights.
  - (d) The investee's key management personnel are related parties of the investor (for example, the chief executive officer of the investee and the chief executive officer of the investor are the same person).
  - (e) The majority of the members of the investee's governing body are related parties of the investor.
- B38 An investor can have power even if it holds less than a majority of the voting rights of an investee. An investor can have power with less than a majority of the voting rights of an investee, for example, through:
- (a) a contractual arrangement between the investor and other vote holders (see paragraph B39);
  - (b) rights arising from other contractual arrangements (see paragraph B40);
  - (c) the investor's voting rights (see paragraphs B41–B45);
  - (d) potential voting rights (see paragraphs B47–B50); or
  - (e) a combination of (a)–(d).

IFRS 10 explicitly includes the concept of 'de facto' control, where an investor with less than a majority of voting rights has power over an investee. The primary focus of the analysis under IFRS

10 remains on whether an investor has sufficient voting rights to give that investor the practical ability to direct the relevant activities. This involves an assessment of the size of its holding of voting rights relative to the size and dispersion of holdings of the other vote holders. An investor therefore needs to consider the indicators given in B42:

B42 When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances including:

- (a) the size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders noting that:
  - (i) the more voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct relevant activities;
  - (ii) the more voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
  - (iii) the more parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;
- (b) potential voting rights held by the investor, other vote holders or other parties (see paragraph B47-B50)
- (c) rights arising from contractual arrangements (see paragraph B40)
- (d) any additional facts and circumstances that indicate the investor has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings.

The Committee would like to draw your attention to following additional facts and circumstances to consider which includes:

- Voting patterns at previous shareholders' meetings
- Whether the investor has the practical ability to direct the relevant activities unilaterally (e.g., the investee and the investor have the same key management)
- Whether the investor has a special relationship with the investee (e.g., the investee depends on the investor to fund a significant part of its operations)
- Whether the investor has a large exposure to variable returns (which may be an indicator that the investor had an incentive to obtain rights sufficient to give it power)

There is an important distinction to be drawn about voting patterns. IFRS 10 makes it clear that the focus is on the number of vote holders that have participated in the past and the absolute proportion of voting rights that have historically been exercised. It is not on whether other vote holders have voted in the same way as the investor.

If the criteria set out below are met, it may be clear that the investor has power over the investee, and no further analysis is needed (refer example 4 of the standard):

- Direction of relevant activities is determined by majority vote
- The investor holds significantly more voting rights than any other vote holder or organised group of vote holders
- Other shareholdings are widely dispersed (IFRS 10.B43/B44).

In other situations the guidance above is not conclusive and further analysis of additional facts and circumstances is required. The fewer voting rights the investor holds, and the fewer parties that would need to act together to outvote the investor, the more reliance is placed on additional facts and circumstances to assess whether the investor's rights are sufficient to give it power (IFRS

10.B45). An Investor has no power if additional facts and circumstances still do not provide a clear answer (IFRS 10.B46).

Additional facts and circumstances also need to be analysed which include indicators of a special relationship with the investee, which suggest more than a passive interest and voting patterns. As noted above, when voting patterns of previous shareholders meetings are analysed, the standard requires only the number of other shareholders that attended (to calculate the majority of votes required to unilaterally make decision) to be considered, but not their voting patterns. Examples 5 to 8 from the standard illustrate how additional rights, and voting patterns, are taken into consideration.

**Conclusion:**

In the light of above, an investor can control an investee with less than the majority of voting rights. The Committee considers that common directorship is not a conclusive factor for determining control. Other factors like contractual arrangements and circumstances discussed above may also require judgment and need to be considered carefully.

Based on all the information provided to us, including the shareholder's agreement, the Committee concludes that:

1. SL does not directly or indirectly controls, beneficially owns or holds more than fifty per cent of PL voting.
2. Group A comprising SL, APL and their subsidiaries has power under shareholders' agreement to appoint four directors out of seven (including chief executive). Under the same shareholders' agreement, the rights of board of directors have significantly been reduced from the usual statutory rights and even most of the ordinary matters to be decided by the general meeting with a majority of at least 2/3rd, with other annual matters requiring approval of the general meeting with 85% voting. This shows that most significant decisions that affect the business cannot be taken without a greater majority.
3. While SL is entitled to variable returns, prima facie it does not have the power over the investee in a host of key matters. Accordingly, based on the information and facts available the Committee is of the view that PL is not the subsidiary of SL.

(May 16, 2016)

## 2.1 INDEBTEDNESS OF AUDITORS

**Enquiry:** We would like to obtain an opinion regarding the indebtedness of external auditors of a banking company, where the firm has obtained an unfunded facility from that banking company.

### ***Relevant Requirements of Companies Ordinance 1984***

Clause (d) of sub section 3 section 254 states that a person who is indebted to the Company shall not be appointed as auditor of a company.

Sub section 3A clarifies that a person shall not be deemed indebted to the company if a person who owes:

- (a) a sum of money not exceeding five hundred thousand rupees to a credit card issuer: or
- (b) a sum to a utility company in form of unpaid dues for a period not exceeding ninety days

### ***ICAP Code of ethics for Chartered Accountants (revised April 28, 2015)***

#### ***Loans and Guarantees***

290.117 states that “a loan, or a guarantee of a loan, to a member of the audit team, or a member of that individual’s immediate family, or the firm from an audit client that is a bank or a similar institution may create a threat to independent. If a loan or guarantee is not made under normal lending procedures, terms and conditions, a self-interest threat would be created that would be so significant that no safeguards could reduce the threat to an acceptable level. Accordingly, neither a member of the audit team, a member of that individual’s immediate family, nor a firm shall accept such a loan or guarantee.”

290.118 states that “if a loan to a firm from an audit client that is a bank or similar institution is made under normal lending procedures, terms and conditions and it is material to the audit client or firm receiving the loan, it may be possible to apply safeguards to reduce the self-interest threat to an acceptable level. An example of such a safeguard is having the work reviewed by a chartered accountant from a network firm that is neither involved with the audit nor received the loan.”

290.119 states that “a loan, or a guarantee of a loan, from an audit client that is a bank or a similar institution to a member of the audit team, or a member of that individual’s immediate family, does not create a threat to independence if the loan or guarantee is made under normal lending procedures, terms and conditions. Examples of such loan include home mortgages, bank overdrafts, car loans and credit card balances.”

#### **Dictionary meaning**

As per Oxford Dictionary:

- ***indebtedness: the condition of owing money***
- ***indebted: owing money***

(source: <http://www.oxforddictionaries.com/definition/english/indebtedness> )

#### **Our queries**

Considering the above requirements of law and ICAP Code of Ethics for Chartered Accountants, we would like to have an opinion of the Committee on:

Would a firm be **deemed indebted** to a banking company in following cases:

- a. If firm has obtained and utilized unfunded facility (guarantee) only?
- b. If firm has obtained funded facility from the banking company but has not utilized that facility?

**Opinion:** The Committee would like to draw your attention to the section 254(3) of Companies Ordinance, 1984 and section 290.117 to 290.118 of revised ICAP Code of Ethics for Chartered Accountants (the Code), already reproduced in your query. These sections of the Code explain scenario and safeguards where loan or guarantee of loan is obtained under normal lending terms or not. However, the requirements of section 254(3)(d) of the Companies Ordinance, 1984 are stricter than the Code and disqualify a person to become an auditor if he/she is indebted to client.

With regard to your queries, the Committee is of the view that if a firm has obtained and utilized unfunded facility that is guarantee, a liability has been created; hence it appears to create indebtedness to firm. In this case, the Committee is of the view that self-interest threat would be created that would be so significant that no safeguards could reduce the threat to an acceptable level. Accordingly, a firm should not accept such guarantee.

For second query, the Committee is of the view that loan comes under funded facility and therefore, guidance can be taken from requirements of section 290.117-290.119 of the Code. In this scenario, as non-utilization of a funded facility is temporary and the facility is obtained with the objective of availing it, therefore, it would also create indebtedness and a risk to self-interest threat as soon as it is utilized. Therefore, the firm should avoid taking such banking facilities from the banking clients in both the scenarios.

**Note:** *In addition to above, the enquirer was also advised to take opinion from legal advisor as it could have legal implications.*

*(November 09, 2015)*

## **2.2 APPOINTMENT OF AUDITOR**

**Enquiry:** One of our client, at their AGM appointed another firm as their Auditor for the audit of next financial year without complying with the provision stated in section 253(2) of Companies Ordinance 1984 as notice of this was not sent to us being the retiring auditor.

We are of the view that the appointment of new auditor was not legally valid as the said provisions of Companies Ordinance were not followed, accordingly NOC to incoming auditor for acceptance of this assignment was not given.

Based on above anomaly in their appointment, the incoming auditor resigned and our client again approached us to appoint us as Auditors for next year.

We have accepted the assignment however are we required to request retiring auditor to give NOC given their appointment was not valid?

**Opinion:** The Committee would like to draw your attention to the requirements of the Companies Ordinance 1984, CA Ordinance 1961 and ICAP Code of Ethics:

**253 Provisions as to resolutions relating to appointment and removal of auditors.** - (1) A notice shall be required for a resolution at a company's annual general meeting appointing as auditor a person other than a retiring auditor.



(2) The notice referred to in sub-section (1) shall be given by a member of the company to the company not less than fourteen days before the annual general meeting, and the company shall forthwith send a copy of such notice to the retiring auditor and shall also give notice thereof to its members not less than seven days before the date fixed for the annual general meeting and, if the company is a listed company, shall also publish it at least in one issue each of a daily newspaper in English language and a daily newspaper in Urdu language having circulation in the Province in which the stock exchange on which the company is listed is situate.

Please also refer clause 7 of Part 1 of 1st Schedule of Chartered Accountants Ordinance 1961 which mentions that:

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

(7) Accepts a position as auditor previously held by another member of the Institute without first communicating with him in writing.”

Section 210.14 of the ICAP Code of Ethics requires the proposed auditor to obtain permission in writing from existing auditor before accepting engagement.

Based on above, the retiring auditor is supposed to receive the notice required under section 253(1) (reproduced above). However, in this case as the compliance of section 253(2) is not made, the Committee is of the view that appointment of new auditor was not legally valid and in effect no auditor is appointed in AGM so the provisions of section 252 (6) and (7) will be applicable and hence the issue of obtaining NOC is not relevant in this situation.

**Note:** Due to the fact that the matter could have legal implications, the Committee sought legal opinion also. Lawyer strongly recommended that the concerned auditor and the company should seek advice from their own legal advisor on the matter.

(December 02, 2015)

## **2.3 NOTICE U/S 161/205 OF THE INCOME TAX ORDINANCE, 2001 ISSUED TO CORPORATION FOR TAX YEAR 2013-14**

**Enquiry:** This query is related to ABC Corporation on which FBR had some observations related to code of ethics compliance for tax year 2013-14.

### **Background:**

ABC Corporation is established in China as a state-owned hydropower project contractor during the 1950s. It has dynamic network including regional divisions and offices in Asia, Africa, Oceania, South America and Europe, supervising 113 overseas branches / representative offices in 84 countries. In Asia, their head office is located in Islamabad. ABC Corporation Limited is listed as a registered taxpayer.

Extract of FBR observation on audit firm of Corporation, M/s XYZ & Company, Chartered Accountants, is reproduced below:

“.....It is further pertinent to mention that not only your firm, M/s XYZ & Company, Chartered Accountants, prepared the Financial Statements and Audited Accounts of the company, in fact they are also the engaging partner of the concerned company which shows either professional incompetence of the firm or deliberate attempt aiming at misleading the undersigned.

It has also been observed that preparation of financial statements and conducting of audit by the same firm and simultaneously representing the taxpayer being tax attorney before the Inland



Revenue Authorities is not only morally wrong but also against the professional ethics and the best international practice in vogue all across the world. In Pakistan, after realizing the same, SECP has changed this practice for public listed companies.”

**Opinion:** The relevant Committee of the Institute (the Committee) has considered the matter and would like to inform you that in 1990 the Institute adopted the International Federation of Accountants’ (IFAC) Code of Ethics for Professional Accountants for the first time with some amendments so that the services provided by its members should be in accordance with the internationally accepted norms and principles. Since then the Institute is following IFAC’S Code. In April 2015, the International Ethics Standards Board for Accountants (IESBA) of IFAC issued a revised Code of Ethics for Professional Accountants, clarifying requirements for all professional accountants and significantly strengthening the independence requirements of auditors in providing their services, which was adopted by the Institute subject to some changes as per local regulatory requirements.

The Committee would like to refer the following paragraphs of ICAP Code of Ethics (the Code) issued in 2008, as the query relates to tax year 2013-14:

- 290.159      The potential threats to independence will most frequently arise when a non-assurance service is provided to a financial statement audit client. .... Threats to independence, however, may also arise when a firm provides a non-assurance service related to the subject matter information, of a non- financial statement audit assurance engagement. In such cases, consideration should be given to the significance of the firm’s involvement with the subject matter information, of the engagement, whether any self-review threats are created and whether any threats to independence could be reduced to an acceptable level by application of safeguards, or whether the engagement should be declined. ....
- 290.164      The provision of certain non-assurance services to financial statement audit clients may create threats to independence so significant that no safeguard could eliminate the threat or reduce it to an acceptable level. However, the provision of such services to a related entity, division or discrete financial statement item of such clients may be permissible when any threats to the firm’s independence have been reduced to an acceptable level by arrangements for that related entity, division or discrete financial statement item to be audited by another firm or when another firm reperforms the non-assurance service to the extent necessary to enable it to take responsibility for that service.
- 290.165      Assisting a financial statement audit client in matters such as preparing accounting records or financial statements may create a self-review threat when the financial statements are subsequently audited by the firm.
- 290.166      It is the responsibility of financial statement audit client management to ensure that accounting records are kept and financial statements are prepared, although they may request the firm to provide assistance. If firm, or network firm, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include:
- Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the financial statement audit client;
  - Authorizing or approving transactions; and
  - Preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.

In addition to above, please refer the safeguards provided in the paragraph 290.162 of the Code when non-assurance services are provided to assurance clients.

### **Financial Statements Audit Clients that are Not Listed Entities**

290.169 The firm, or a network firm, may provide a financial statement audit client that is not a listed entity with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level.

Examples of such services include:

- Recording transactions for which the audit client has determined or approved the appropriate account classification;
- Posting coded transactions to the audit client's general ledger;
- Preparing financial statements based on information in the trial balance; and
- Posting the audit client approved entries to the trial balance.

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, **safeguards should be considered** and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Making arrangements so such services are not performed by a member of the assurance team;
- Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the audit client;
- Requiring the source data for the accounting entries to be originated by the audit client;
- Requiring the underlying assumptions to be originated and approved by the audit client; or
- Obtaining audit client approval for any proposed journal entries or other changes affecting the financial statements.

In the light of above, the Code allows unlisted company's auditor to prepare financial statements and also to perform audit, provided safeguards are in place.

With regard to providing tax related advisory services, the Committee would also like to draw your attention to para 290.176 of the Code:

290.176 The firm may be asked to provide taxation services to a financial statement audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.

The Committee is of the opinion that the external auditor may engage in tax advisory services. However, certain tax services may also pose a threat in the form of self-review and/or advocacy for which the auditor needs to take care of by applying the necessary safeguards.

In addition to above, the Committee would also like you to refer section 290.175-290.188 pertaining to the taxation services of the revised ICAP Code of Ethics 2015 which is effective for audits of financial statements for periods beginning on or after July 01, 2015. In section 290.179-290.180, the revised Code distinguishes between the requirements for listed and unlisted clients, otherwise it allows external auditor to perform varied taxation services that are mentioned in the Code.

The full copy of the ICAP Code of Ethics can be accessed at:

<http://www.icap.net.pk/wp-content/uploads/2013/12/Code-of-Ethics-2008.pdf>

<http://www.icap.net.pk/wp-content/uploads/2013/12/ICAP-revised-Code-of-Ethics-2015.pdf>

(May 09, 2016)