



CA
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Selected Opinions Volume XXII

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Technical Services Department

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Introduction

This report is the twenty second compilation of selected opinions issued by the Technical Advisory Committee on inquiries raised by the members and other agencies during the period from **July 2016 to June 2017** 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 provided by the enquirer, it may change if the facts and the circumstances change. An opinion may also change due to subsequent developments in law, pronouncements made by the Institute and other relevant changes. 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

ACCOUNTING

1.1 Presentation of Capital Advances

Enquiry: The Company has been incorporated last year to establish two power plants. These projects are fully sponsored by the Federal Government. The Company has entered into EPC agreements with two different international companies. One of them has opted for 15% advance payment. After advance, all payments will be based on work completion certificates. Every subsequent payment will be subject to 15% adjustment on account of advance payment. This EPC agreement includes erection, procurement of machinery, turbines (whole plant equipment), construction and full commissioning of the plant.

We need your technical advice as to how these advances will be presented in the balance sheet of the Company on reporting dates where these advances represent millions of dollars and will be adjusted over a period of 27 months.

We have enquired from different sources and came up with different options, for example (i) to classify these advances in CWIP; or (ii) to present these advances as long term advance in balance sheet before current assets.

Opinion: The Committee considered your query and would like to draw your attention to the following paragraphs of IAS 16 ‘Property, Plant & Equipment’:

Para 6 defines **cost** as follows:

“**Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction in accordance with the specific requirements of other IFRSs, e.g. IFRS 2 Share-based Payment.”

“Elements of cost

16 The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.”

“17 Examples of directly attributable costs are:

- (a) costs of employee benefits (as defined in IAS 19 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;
- (b) costs of site preparation;
- (c) initial delivery and handling costs;
- (d) installation and assembly costs;
- (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
- (f) professional fees.”

As per conceptual framework “asset” is recognized in the balance sheet when it is probable that the future economic benefits will flow to the entity and it is a resource controlled by the entity. Therefore, the Committee feels that presentation of advance to contractor either as CWIP or Advance in financial statements depends upon the specific terms of the contract. CWIP would normally correspond with physical completion of work in progress, whereas mobilization advance represents a payment to contractor to facilitate CWIP as per contractual terms. Risk and reward of ownership of “asset under construction” must be looked into with reference to terms of contract in order to determine the presentation. If risk and reward of ownership passes to Company with partial delivery then advance must be reclassified to CWIP accordingly.

4th and 5th Schedule of the Companies Ordinance 1984 requires CWIP (including significant item wise detail) to be presented as item of Property, Plant & Equipment (PPE). While para 74(b) of IAS 16 also requires disclosure of amount of expenditure recognized in the carrying amount of an item of PPE in the course of its construction.

In the light of above, the Committee is of the view that advances are required to be classified as long term Advance and they will be transferred to CWIP when the transfer of risk and reward in the under construction assets takes place and an identifiable asset is created. Such advance would remain as non-current till it is transferred to CWIP, as in the normal circumstances, it is not expected to realize into working capital of the company.

(July 04, 2016)

1.2 Clarification regarding definition of Gross Revenue

Enquiry: A Telecommunication Authority (the Authority) was constituted under Pakistan Telecommunication (Re-organization) Act 1996 to regulate the establishment, operation and maintenance of Telecommunication Systems and the provision of Telecommunication Services in Pakistan.

In order to regulate the Telecom sector in Pakistan, the Authority issues various licenses to different companies. As per the license terms and conditions, the licensees are required to pay Annual License Fee (ALF), Universal Services Fund (USF) Contribution and Research & Development (R & D) Contribution. As per license terms and conditions, these Fees and Contributions are calculated as follows:

"The ALF, USF and R&D Contribution shall be calculated on the basis, of 0.5%, 1.5% and 0.5% respectively, of the licensee's Annual Gross Revenue from Licensed Services for the most recently completed financial year of the licensee minus inter operator payments and related Authority's mandated payments. However, Initial License Fee and Initial Spectrum Fee shall not be deducted from the gross revenue."

Keeping in view the above license term, the Authority issues demand notices to licensees and calculate the amount payable by the licensee as follows:

Annual Gross Revenue as Disclosed in Financial Statements of licensee	x,xxx,xxx
Less: Sales Tax/ Federal Excise Duty	(xxx,xxx)
Revenue as recognized in Income Statement	x,xxx,xxx
Less Inter operator payments	(x,xxx,xxx)
Less: the Authority mandated payments	<u>(x,xxx,xxx)</u>
Adjusted Gross Revenue	<u>x,xxx,xxx</u>
Annual License Fee @ 0.5% of Adjusted Gross Revenue	x,xxx,xxx
R&D Contribution @ 0.5% of Adjusted Gross Revenue	x,xxx,xxx
USF) Contribution @ 1.5% of Adjusted Gross Revenue	x,xxx,xxx

The financial statements of the Authority are audited by government Auditors and they have raised an objection in calculation mentioned in para 3 above. The government auditor's opinion is as follows:

"The Gross Revenue means the turn over or gross income from the license services exclusive of trade discount shown on invoice of bills, derived from sales of goods or from rendering, or supplying services or benefits or of contracts. Hence, accordingly to terms and conditions, Sales Tax/ federal excise Duty is part of gross revenue for the purpose of calculation of ALF, USF Contribution and R&D Contribution.

The point view of licensees is given below, which was accepted by the Authority:

- a. Para 7 of IAS 18 'Revenue' defines Revenue as "the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants."
- b. Para 8 of IAS 18 further explains that "Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties such as sales taxes,

goods and services taxes and value added taxes are not economic benefits which flow to the entity and do not result in increases in equity.”

Clause 2 (a) of Part III "Requirements as to Profit & Loss Account" of the 4th schedule of the Companies Ordinance 1984 states that Profit & Loss Accounts shall disclose the turnover after deduction of discount and sales tax, therefore the companies disclose gross revenue and then deduct tax from gross revenue in "Notes to the Accounts" and the Net Revenue is disclosed in the income statement.

From the above, it is evident that taxes i.e. FED, Sales Tax etc. do not form part of gross revenue so it is not justified to charge Regulatory dues (ALF, USF and R&D) on the amounts which are not earned by operators. This view is further endorsed by the fact that licenses do not state that FED/Sales tax are part of gross revenue.

ICAP is requested to give their opinion whether sales tax forms part of Revenue or not keeping in view the facts mentioned above.

Opinion: Considering the provisions of IAS 18, the Committee agreed with the point of view of licensee that sales tax do not form part of gross revenue.

(July 25, 2016)

1.3 Defined Benefit Plan under Section 28 of the IFRS for SMEs

Enquiry: This inquiry pertains to Gratuity plan of a Company. Section 28.15 (a) requires an entity to measure defined benefit obligations at the present value. Section 28.17 elaborates the procedure for calculating the discounted present value. An entity has the option to either calculate defined benefits under 'projected unit credit method' as described in section 28.18 OR under the permitted simplifications as explained in section 28.19.

Our first question is that if an entity opts for section 28.19, will it still be required to work out the discounted present value? Kindly provide the opinion of relevant committee in this regard.

The relevant sections mentioned above are reproduced below:

“28.15 An entity shall measure a defined benefit liability for its obligations under defined benefit plans at the net total of the following amounts:

(a) the present value of its obligations under defined benefit plans (its defined benefit obligation) at the reporting date (paragraphs 28.16-28.22 provide guidance for measuring this obligation), minus

(b) the fair value at the reporting date of plan assets (if any) out of which the obligations are to be settled directly. Paragraphs 11.27-11.32 establish requirements for determining the fair values of those plan assets that are financial assets.”

“28.17 An entity shall measure its defined benefit obligation on a discounted present value basis. The entity shall determine the rate used to discount the

future payments by reference to market yields at the reporting date on high quality corporate bonds. In countries with no deep market in such bonds, the entity shall use the market yields (at the reporting date) on government bonds. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated period of the future payments.”

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

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

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

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

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

Our second question is with reference to section 15.6 read with section 15.8 of the "Accounting and financial Reporting Standards for Small-Sized Entities" (AFRS for SSEs) where unfunded gratuity provision is made as under:

"However, an entity may opt to calculate the accrued liability by reference to any other rationale method e.g. a method based on the assumption that such benefit are payable to all employees at the end of the accounting year".

Will discounting be required to work out present value in the above case?

Opinion: The Committee would like to draw your attention to the following paragraphs of IFRS for SMEs:

Actuarial valuation method

*“28.18 If an entity is able, without undue cost or effort, to use the **projected unit credit method** to measure its defined benefit obligation and the related expense, it shall do so.....”*

*“28.19 If an entity is not able, without undue cost or effort, to use the **projected unit credit method** to measure its obligation and cost under*

defined benefit plans, the entity is permitted to make the following simplifications in measuring its defined benefit obligation with respect to current employees:

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

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

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

Section 28.18 spells out that an entity shall use projected unit credit method to measure provision for gratuity. Section 28.19 of the IFRS for SMEs provides the mechanism to work out provision for gratuity where an entity is not able to use the projected unit credit method. In the simplified version there are no salary increases and services assumed for future (i.e. closure of the plan assumed) this is called "discontinuance approach" in which case no discounting is required.

This concession conveys the same meaning as by section 15.6 of the Accounting & Financial Reporting Standards for SSEs which is reproduced below:

*"However, an entity may opt to calculate the accrued **liability** by reference to any other rationale method e.g. a method based on the assumption that such benefit are payable to all employees at the end of the accounting year ".*

Hence, the Committee is of the view that the provision for gratuity under section 28.19 of IFRS for SMEs and section 15.6 of AFRS for SSEs will be calculated without discounting for present value, that is, "closure of the plan" and "benefits are payable to all the employees at the end of the accounting year".

(August 26, 2016)

1.4 Real Estate Project accounting on the basis of Percentage of Completion Method

Enquiry: The Technical Committee is requested to give its opinion on the revenue recognition policy of the Company which is engaged in the real estate development, sale and management business (the "Company"), including housing schemes (plots, townhouses), shopping plazas, multistoried apartment towers, etc. The Company already sold many projects of developed plots and also has sold some projects of constructed houses. The Company being an economically significant entity is required to prepare its accounts in accordance with Financial Reporting Standards as notified by the SECP. The Company consistently applied percentage completion method since its inception for the recognition of its revenue on all its project sales. Assuming there has been no change in the

auditors and auditors never had any question about the appropriateness of the percentage completion method.

Understanding Business of the Company

Before discussing revenue recognition policy of the Company, it is pertinent to understand here the business model of the Company which is similar to general norms of the Real Estate Development business in Pakistan. The Project starts with the acquisition of Land in the areas where the Company plans to launch its projects. When sufficient land has been acquired by the Company, an application is submitted to the concerned Regulatory Authority (LOA, FDA, CDA, etc.) for preliminary planning permission. The relevant Authority, after taking care of the stakes of the other parties including the Government itself in accordance with the Master Plan of the city, grants such approval for the development and launch of the project. After this initial approval, a detailed layout plan along-with other technical drawings (Electrical Water and Sewerage etc.) as approved by the concerned Government Agencies is formally submitted with the Regulatory Authority for its approval of the scheme's layout plan. After the approval from the Regulatory Authority, the Company starts the initial physical development activities at the Project site.

After all the above has taken place, and at the initial stages of development, the project is normally launched on installment plans. The upfront land purchase cost which is a significant portion of the total project cost is mostly financed by the Company from equity funds; however, major development cost is financed through bank loans and receipts of initial booking and installments monies from clients after the launch of the project. Approved detailed plans include plot numbers / house numbers which are allocated to the applicants through balloting if sales are more than available inventory. Monies to the un-successful applicants are returned at such stage whereas the successful applicants become clients of the Company whose units (plots or houses) are identifiable on the approved drawings. These clients keep on paying installments and the Company keeps on completing the development work.

The project's estimated revenue, project estimated cost and the project completion time-lines are planned in such a way that all inflows and outflows of the project correspond to ensure the project completion within the expected time lines. Please note all these estimates can be reliably calculated keeping in view the sale price (already fixed), construction contracts awarded to contractors by the developer, materials current costs and anticipated inflation, etc. According gross profits can also be reliability computed for the year as well as for the entire life of the project. Any changes in subsequent years are considered changes in estimates and are accounted for in accordance with the relevant accounting standards. Revenue and costs are reflected in profit and loss account in accordance with matching principle using percentage completion method. (In cases where no land is purchased, naturally no development work can be done on 'non-existent land' and despite advance booking of plots and receipt of money from bookings, no revenue can be booked as the completion will be Zero therefore such instances are not subject of our this discussion as those do not qualify for percentage completion concept). The process ends on when the entire product (Plots/Houses) in the project has been delivered and the project has also been

handed over to the local Project Management Society (PMS) for onward project management.

Project Sales

Going into further details of the project launch, it is being explained that on every project booking applications are invited from the general public for subsequent balloting by the Company for allocation of plots/houses to the general public against their applications. In some cases, applications received are equal to or less than the total inventory of the plots/houses available with the Company (Hereinafter referred to as “**Category X sales**” where all the clients are allocated plots/ houses against their applications through balloting process. The clients are communicated with their relevant house/ plot number along-with copy of the approved map of the project. They can trace their plot/ house on the approved map which can’t be changed without their consent once the same has been communicated to them. In some other cases the applications received by the Company from general public exceed the total inventory of the plots/ houses available with the Company. In this case, those clients who got the plot/house allocated through balloting process of the Company are communicated with their relevant house/plot number along-with copy of the approved map of the project. These sales are hereinafter referred to as “**Category Y sales**”. The rest of the clients are then accommodated by the Company in 2nd phase of the project after acquiring further land adjacent/near by the existing project (Phase 1) of the Company. Sales to such clients are hereinafter referred to as “**Category Z sales**”. These clients are communicated about their plot/house number once the Company has acquired the requisite land and the project extension/Phase 2 of the project has also been approved by the regulatory Authority.

Installment sales and Securitization of Project receivables

Since all the sales are based on installment plans therefore to securitize the project receivables following clauses are used in the sale agreements entered into by the Company with its clients purely from the credit management point of view:

- *Completion of the Sale Deed of the House/ Property and registration in the name of the client will be done once all the dues have been cleared.*
- *This sales agreement will not create legal right, title in the property in favor of the client until a registered sales deed is executed in favor of the client.*
- *Client will not transfer the allotted Property until and unless prior written permission of the Company is obtained.*

It is pertinent to mention here that the objective of these clauses is purely to secure the project receivables and not to restrict the rights of the clients towards the ownership of the property. All risks and rewards are fully transferred (One of the main conditions for revenue recognition in Para 14 of IAS 18) to the clients as they can resell their properties in open market at gain or loss by clearing all his dues to-date with the Company. In this way all benefits of progress in construction and development goes to the client and the Company is not beneficiary of such

gains. The Company is only entitled to recover the booked price and not the market price from its clients before transferring the legal title in favor of clients.

As mentioned in earlier paragraphs, the project's completion and recovery of installments from clients are timed in such a way that the last installment is paid to the company upon handing over of completed unit's possession. According to market norms clients stop making installments payments in case developer slows down or is delaying completion of the project. Upon completion of the unit, assuming all the dues by the clients are clear, clients can apply for sale deed in their favor, the Company never refused to entertain such requests of its clients provided that nothing stands outstanding against the clients in the books of account of the Company. However a sale deed technically/ legally may not be signed if the project is yet not completed as relevant authorities will not record a registry or if the Company offers sale deeds to its clients without recovering all its dues, especially when physical possession of the property is already with the client as per the terms of agreement, it will become impossible to recover the pending dues from the clients. However, the increases in unit's (plot or townhouse) price or a reduction in price of the unit is totally to the account of the client and company neither benefits nor accepts losses from the same.

Therefore the objective of the insertion of these clauses is just to ensure recoveries from the clients. This is also in accordance with substance over form concept of the Accounting Principles. Further these clauses are also in conformity with the requirements of Para 15 of IAS 18 as given below:

“The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales. In other cases, the transfer of risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession.”

It is clearly stated in the above mentioned Para of IAS 18 that transfer of risks and rewards may occur at some different time than transfer of legal title or passing of possession.

Revenue Recognition Policy of the Company

Company has entered into sale agreements (Developed plot, Constructed house or Commercial plot) with large number of its clients. The revenue recognition policy consistently being applied and as disclosed in its Financial Statements is given as under:

“Revenue from sale of plots, houses and commercial areas is recognized by applying stage of completion method. Revenue is recognized by the proportion that project costs incurred for work performed to date bears to the estimated total cost of the project. Unrecognized revenue represents the portion of the value of houses sold by the Company under agreement to sell to clients and would be recognized as revenue by transfer to profit or loss in subsequent years”

It is pertinent to mention here that in case of “**Category X sales**” and “**Category Y sales**”, the Company has incurred major project cost in shape of land buying and in shape of part development of the project as on the date of project launch, whereas, in case of “**Category Z sales**” no cost is yet incurred by the Company as on the date of project launch. Accordingly only revenue pertaining to “**Category X sales**” and “**Category Y sales**” is recognized using percentage completion method whereas no revenue is recognized in case of “**Category Z sales**” till the date the Company has started incurring costs in respect of these sales. These sales shall appear as liability in the Balance Sheet under the heading “**Unrecognized revenue**” till the date the Company has started incurring costs in respect of these sales. The accounting treatment for “**Category X sales**” and “**Category Y sales**” is same.

The Company is recognizing its revenue according to the percentage completion method in accordance with International Accounting Standards as explained below:

IFRIC- 15 ‘Agreements for the construction of Real Estate’ contains the detailed guidance to determine whether these agreements are within the scope of **IAS 18** or **IAS 11** and when the revenue from these agreements should be recognized.

According to **Para 12 of IFRIC-15**, an agreement for the construction of real estate in which buyers have only limited ability to influence the design of the real estate, e. g. to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, is an agreement for the sale of goods within the scope of **IAS 18**. The Company in question offers standard products to its clients whereby they can choose from a few models and sizes in terms of ground space and constructed space while no changes are accepted which are not part of the approved plans from the development authorities (LDA, FDA, CDA, etc.), therefore, the revenue shall be recognized within the scope of **IAS 18** as sale of goods.

As per **Para 16 and 17 of IFRIC-15**, if the entity is required to provide services together with construction materials in order to perform its contractual obligation to deliver the real estate to the buyer, the agreement is an agreement for the sale of goods and the criteria for recognition of revenue set out in paragraph 14 of **IAS 18** apply. Simultaneously, the entity may transfer to the buyers the practical ownership control and the risks and rewards associated with the ownership of the work in progress in its current state as construction progresses. In this case, if all the criteria in paragraph 14 of **IAS 18** are met continuously as construction progresses, the entity shall recognize revenue by reference to the stage of completion applying the percentage of completion method.

According to para 14 of **IAS 18**, Revenue shall be recognized when all the following conditions have been satisfied:

- (a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
- (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- (c) the amount of revenue can be measured reliably;
- (d) it is probable that the economic benefits associated with the transaction will flow to the entity; and

- (e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

As already discussed, the Company in question transfers all the significant risks and rewards associated with the properties sold to the customers. The customers are free to sell their properties to third parties to make gains provided that they have adhered to the other terms and conditions of the agreement.

Further, the Company transfers to the buyer control and the significant risks and rewards of ownership of the properties being sold by the Company to its clients as the construction progresses. The benefit of the increase in prices of properties as a result of development and construction activities at individual projects goes to the clients and they can make gains by selling their properties at market prevailing prices which is normally on higher side than the prices charged by the Company. The Company is only entitled to recover the booked price from its clients.

In light of the above discussions, the Company is recognizing its revenue by reference to the stage of completion of the individual projects by applying the percentage completion method. This accounting policy is being consistently followed by the Company since many years.

The Institute of Chartered Accountants, based on information provided by SECP in its query along-with sample agreement, is of the view that the terms and conditions of Sale Agreement mentioned in clause 19, 20 and 23 state that:

- Completion of the Sale Deed of the House/ Property and registration in the name of the client will be done once all the dues have been cleared.
- This sales agreement will not create legal right, title in the property in favor of the client until a registered sales deed is executed in favor of the client.
- Client will not transfer the allotted Property until and unless prior written permission of the Company is obtained.

According to ICAP, based on information provided, risks and rewards are not fully transferred to the client as well as control/ managerial involvements of the units sold will remain with the Company and therefore, the requirements of para 14 (a) and (b) of IAS 18 are not being complied. Keeping in view of the requirements of para 17-18 of IFRIC 15, the Committee is of the view that the revenue from the sale of housing scheme will be recognized when all the requirements of para 14 of IAS 18 are fulfilled. Whereas, in the same opinion the Institute is of the opinion that the accounting treatment of Receivables is correct.

Institute's opinion that risks and rewards are not fully transferred merely on the basis of above mentioned clauses in the agreement is in conflict with para 15 of IAS 18 and the concept of Substance over form as well. The view point of the Company has already been summarized above on the objective of these clauses used in the agreement.

Further there is a confusion that if the Company can't recognize revenue then how receivables as a result of these sales could be recognized.

Tax laws in Pakistan also require the accounting of long term contracts using percentage completion method.

The Technical Committee of the Institute is requested to provide clarifications on these confusions raised by the Company so that correct accounting treatment could be ensured in Real Estate Industry.

Opinion: The Committee considered your enquiry and would like to draw your attention to paragraph 14-16 of IAS 18 '*Revenue*' which deals with revenue recognition on the basis of the requirement of transfer of risk and rewards of ownership of the goods. Based on the information provided in the previous TAC query which you have referred, risks and rewards were not fully transferred as well as control/ managerial involvements of the units sold remained with the Company and therefore, the Committee was of the view that requirements of para 14 (a) and (b) of IAS 18 were not being complied. Further, para 17-18 of IFRIC 15 '*Agreements for the construction of Real Estate*', also reinforce that the revenue from the sale of housing scheme will only be recognized when all the requirements of para 14 of IAS 18 are fulfilled. Accordingly, this Committee maintains the previous opinion on the matter.

However, paragraphs 35-37 of IFRS 15 '*Revenue from Contracts with Customers*', which is applicable for periods beginning on or after 1st January, 2018 but not yet adopted and notified in Pakistan, set out the criteria where an entity should recognize the revenue over time and failing which an entity satisfies the performance obligation at a point of time and therefore should recognize the revenue in accordance with requirements stipulated in paragraph 38.

With respect to recognition of receivable with a corresponding credit to advance from customers, the Committee agrees that this was perhaps not consistent with the current practice. Advance from customer is to be recognized as liability as and when installments are received rather than recording of receivable from customer on an accrual basis as per the installment plan.

(07 September 2016)

1.5 Opinion required on treatment of Rebate

Enquiry: We are an IT export oriented Public Unlisted Company (registered in Pakistan). The query is related to discount/ rebate given by our Company to one of its USA customer.

One of our USA customers has entered into an agreement with us for delivery of some specific software development related services.

There is only one legal agreement by the name of Master Corporate Service Agreement (MCSA) dated 01st February 2015 and there are two amendments in this MCSA effective from 1st February 2016 (10% quarterly rebate) and effective from 1st May 2016 (20% quarterly rebate) respectively. On 30th June 2016, 100% work has been delivered and 100% amount has been received against work done.

1. From agreement and amendment it is not clear that why we are paying this rebate, however, BOD is of the opinion that we are paying this amount as commission because we are getting business from them. NCR, our customer is procuring our services for one of its customer. It is emphasized that we have no direct link with that customer. We are delivering our work to NCR and receiving our all payments from NCR.

2. Payment on quarterly basis is the payment methodology/ timing whereas we are following accrual basis of accounting and we are booking rebate amount whenever we generate invoice (definition of liability is fulfilling) which means in any case we need to pay the rebate amount as agreed in amendment.

We have not yet paid any discount/ rebate amount to customer. As per agreement, this is rebate and there is no mention of 'commission amount'. However, we are required to pay this rebate in cash to our customer.

The Institute is requested to give its opinion about the treatment of this amount as rebate (whether should it be deducted from gross sales) or as Commission expense (should become part of selling and marketing expense).

Opinion: The Committee would like to refer clause 2 (a) of Part III "Requirements as to Profit & Loss Account" of the 4th schedule of the Companies Ordinance 1984 which states that Profit & Loss Account shall disclose the turnover after deduction of discount and sales tax.

Academically any reduction given to the customer on sales invoice (trade discount) is shown as a deduction from gross sales whereas cash discount (not mentioned on the invoice and arisen due to subsequent events like early payment by customer etc.) is shown separately as expense. In the given case although the rebate is not shown on the sales invoice but it is not dependent on a future event either.

In case of Commission, tripartite agreement shall be there where one is agent, one principal and one is customer/consumer. Since in this case, amount is payable to the same customer under a bilateral agreement, therefore, the Committee is of the view that it may be shown as a deduction from the gross sales and will not be treated as commission expense. Further, as the amount has not been paid so far to the customer, therefore, it would be accounted for on accrual basis as 'payable'.

(October 20, 2016)

1.6 Clarification on applicability of IAS- 41 "Agriculture" on Poultry Industry

Enquiry: We are thankful for referring ICAP Selected Opinion No. 1.10 of Volume 19 (XIX) dated November 08, 2013.

In this regard, it is submitted that in the enquiry, three questions were raised, which are being reproduced for your kind consideration:

I) Whether the cost of breeding the bird is to be treated as biological asset

- or inventory?
- 2) If it is treated as biological assets at what cost it should be recognized?
 - 3) How the cost of biological assets is to be charged cost of production?

Considering the above question raised, the opinion provided by learned Committee is clear regarding Question 1, however, Question 2 & 3 are answered in generality.

In this regard, you are requested to kindly provide specific answers to Question 2 & 3 above and provide the guidance on accounting treatment of "biological assets" in financial statements i.e. how biological asset is to be recognized and how biological assets will be consumed over its useful life, whether on cost or fair value less cost to sell and how to charge biological assets to cost of production/sales.

Opinion: The Committee noted the following opinion regarding Question 1 provided by earlier Committee:

As regards to other two questions, the Committee would like to draw your attention to the following relevant paragraph of IAS 41: (underline is ours)

26. A gain or loss arising on initial recognition of a biological asset at fair value less costs to sell and from a change in fair value less costs to sell of a biological asset shall be included in profit or loss for the period in which it arises.

51. The fair value less costs to sell of a biological asset can change due to both physical changes and price changes in the market. Separate disclosure of physical and price changes is useful in appraising current period performance and future prospects, particularly when there is a production cycle of more than one year. In such cases, an entity is encouraged to disclose, by group or otherwise, the amount of change in fair value less costs to sell included in profit or loss due to physical changes and due to price changes. This information is generally less useful when the production cycle is less than one year (for example, when raising chickens or growing cereal crops).

The first part of para 26 explains gain/loss on initial recognition of a biological asset (procreation/ new breed). Whereas, the second part about the changes in fair value less costs to sell of biological assets, represents the difference/changes in value from period to period, normally on an aggregated basis. Changes in fair value may be due to both physical changes and price changes in the market. A reconciliation of changes in the carrying amount of biological assets between the beginning and the end of the period is also required under IAS 41 para 50.

In light of above, the Committee is of the view that fair value and physical changes are required to be taken to P&L account.

(November 07, 2016)

1.7 Observance of Physical Stock Check

Enquiry: I have been appointed as auditor of the Private Limited Company as at October 31, 2016 but the predecessor auditor did not conduct the audit of the company for the

year ended June 30, 2016. I have communicated the predecessor auditor and found that they had observed physical stock check as at June 30, 2016. They also agreed to share with me working papers subject to client's permission.

A query is do I still need to modify my opinion with respect to observation of stock check?

Opinion: The Committee would like you to refer paragraphs 4 to 8 of ISA 501 '*Audit Evidence*' which specifically addresses your matter.

Auditor is responsible for giving an opinion on the financial statement prepared in the term for which he/she is appointed. In your inquired scenario, the ultimate responsibility will remain of the existing auditor, no matter whether predecessor auditor agreed to share their working papers.

The Committee is of the view that, if the auditor is unable to attend the physical inventory count due to unforeseen circumstances, the auditor should take or observe physical count on an alternative date and, when necessary, perform tests of intervening transactions.

Where attendance is impracticable, due to factors such as the nature and location of the inventory, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that the auditor need not make reference to a scope limitation. For example, documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count may provide sufficient appropriate audit evidence.

With regard to modification of opinion, the Committee would like to refer paragraph 7 of ISA 501 for guidance.

(December 14, 2016)

1.8 Presentation of Financial Statements

Enquiry: Our Company is public unlisted company, registered under Companies Ordinance, 1984, since 1991. We are Economically Significant Company and stakeholders of our financial statements are shareholders, creditors, debtors and commercial Banks.

Our Company has revalued its non-current assets comprise of land, building and plant & machinery. Revaluation was carried out in May, 2014 and incorporated the revaluation surplus amounting to Rs.1.8M in financial statements of 2014. However, the incremental depreciation on revaluation surplus is so high that it converts Company's operating profit into operating loss. As incremental depreciation is initially included in cost of sales and added back in other comprehensive income subsequently.

Based on the information provided, the operating loss amounting to Rs. 3M and loss before WWF amounting to Rs. 8M, resulting from the presentation mentioned above is not presenting the true picture of our operating activities. The factual

position is that the Company has earned operating profit amounting to Rs. 133M and profit before WWF is amounting to Rs. 128M. Furthermore, this situation is creating a very uncomfortable position for our banks as they mostly use operating profit for assessment of company's performance.

It is requested to please guide us whether in our opinion; deviation from International Accounting Standards appears to be only solution here. Your response in this regard will help us to ensure the compliances, with all the applicable laws in time.

Opinion: The Committee would like to refer paragraph No. 19 and 20 of IAS 1 'Presentation of Financial Statements' which permits departure under extremely rare circumstances where management concludes that compliance with a requirement in IFRS is very much misleading.

In the inquired scenario, it is opined that departure will not be applicable because it was an accounting policy choice of the Company to go for the revaluation model.

Further, the Committee is also of the view that depreciation will be charged on revalued amount as per requirements of IAS 16 '*Property, Plant and Equipment*'. Accounting for revalued Property, Plant and Equipment as prescribed under IAS 16 gives a true reflection of use of asset under revaluation model; therefore, the same should be adopted.

Based on the information provided, the presentation of the incremental depreciation as an item of other comprehensive income, is incorrect. The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

(December 26, 2016)

1.9 Treatment of unrealized mark-up on Advances

Enquiry: ICAP is requested to please provide clarification on the treatment of unrealized mark-up on advance on the following matter as per applicable accounting standards.

Some of the banks/ DFIs have given advances to XYZ Company, which defaulted on the payments, so the mark-up was suspended in the books of the banks. However, XYZ Company was later acquired by ABC Company and in turn; these advances (liabilities of XYZ Company) were transferred to ABC Company.

It may be noted that the banks had a total exposure of Rs. xx billion (Outstanding Rs. xxx million as of 30-09-2016) on XYZ Company. The suspended mark-up as of 30-09-2016 stood at Rs. xxx million.

After the acquisition, one of the leading banks approached the SBP to allow it to take the unrealized mark-up to the income account due to improved risk profile of the borrower (new ABC Company). SBP advise the banks to recognize the suspended mark-up only when realized in cash.

Nonetheless, the bank claims that both amount (principal and mark-up) are today expected to be fully recoverable based on the credit standing and performance of the ABC Company. Previously, there was a concern that the amount due would not be recoverable from the XYZ company, however after the acquisition, the market standing of the ABC company has further strengthened and the amount are expected to be fully recovered. The bank has requested to take the suspended mark-up to the income by saying that the previously suspended markup now satisfies the conditions of recognizing the revenue as per IAS 18; stated below.

International Accounting Standard 18 ‘Revenue’ requires that revenue shall be recognized when following criteria are met:

- Reliable measurement of consideration
- Probability that the economic benefits associated with the transaction will flow to the entity.

The revenue is measurable and the probability of it flowing to the bank is no different from the probability of the principal flowing to the Bank, which is recognized at full amount. In order to recognize these claims, the recognition of the principal will simply require a change in obligor in the books of the bank (i.e. from XYZ to ABC Co). However, there is no receivable outstanding in the books against the suspended markup as the receivable was reversed from the books when the markup was suspended. Therefore, as a first step, the claim in respect of the suspended markup will have to be recognized as a receivable, with a corresponding credit to income.

Further, the bank sated that in order to not recognize the previously suspended markup as income (until received in cash), while still maintaining the claim against this amount, it would have to debit the income and take a provision against this claim. Since this is now a claim against ABC Co, it would be tantamount to questioning the recoverability of a claim against ABC. It could also cause negative repercussions for ABC as any reversal of markup would imply that there are questions about either the ability or the willingness of ABC to settle this claim. Since there is no doubt of the recoverability of all other claims on ABC which are significantly larger than this amount, it could be maintained that there is also no need to doubt the recoverability of the claim against the previously suspended markup.

During this issue, SBP highlighted the fact that mark-up payment is due to be received at a future date i.e. in 2024. In this regard the bank states that the criteria for recognition of an asset should be dependent on the probability of the recoverability of the asset rather than the timing of the recoverability of the asset. While the first installment of the previously suspended markup will now be due for payment in Jan 2024, the last principal installment of the loan is due in December 2023. Hence, if the much larger principal that is due in future is considered good

and fully recoverable, then it would not be unreasonable to also consider the markup, which is due only one month later, good, and fully recoverable.

Opinion: The Banks/DFIs prepare their financial statements in accordance with the approved accounting standards as applicable in Pakistan, which comprise of:

- International Financial Reporting Standards (IFRSs) and Islamic Financial Accounting Standards (IFASs) as notified under the Companies Ordinance, 1984;
- provisions and directives issued under the Companies Ordinance, 1984;
- provisions and directives issued under the Banking Companies Ordinance, 1962; and
- the directives issued by the Securities Exchange Commission of Pakistan (SECP) and the State Bank of Pakistan (SBP).

However, in case requirements of provisions and directives issued under the Banking Companies Ordinance, 1962, Companies Ordinance, 1984 and the directives issued by SBP and SECP differ from requirements of IFRSs and IFASs, the provisions of and directives issued under the Banking Companies Ordinance, 1962, the Companies Ordinance, 1984 and the directives issued by SBP and SECP shall prevail.

In the enquired scenario, i.e. the recognition of un-realized mark-up on classified loans/advances by banks/DFIs, the requirements of IAS 18 '*Revenue*' are not relevant, and the financial instrument recognition criteria, outlined in IAS 39 '*Financial Instruments: Recognition and Measurement*' has to be considered and fulfilled. However, the SBP has deferred the applicability of IAS 39 for the banks/DFIs, and has issued directives, prescribing the recognition and measurement criteria of the financial instruments. Accordingly, the banks/DFIs recognize and measure financial instruments related transactions in accordance with the SBP issued directives. The SBP has issued Prudential Regulations for Corporate/Commercial Banking (the Regulation), advising the Banks/DFIs to ensure compliance of the Regulation in the letter and spirit.

The Regulation-8, "Classification and Provisioning for Assets", explains the criteria and provides detailed guidance for the classification and provisioning of assets, including the treatment of suspended/un-realized mark-up of classified advances. The Regulation-8 is reproduced below for reference purposes:

"1. Loans/Advances:

- a) Banks/DFIs shall observe the prudential guidelines given in Annexure-V in the matter of classification of their asset portfolio and provisioning there against on the time based criteria."*

The Annexure-V of the Regulation provides guidelines to the Regulation-8, including the treatment of income related to the classified loans/advances. In accordance with the guidelines of Annexure-V, the suspended/un-realized mark-up on a classified loans/advance is recognized on the receipt basis. The relevant part of the Annexure-V of the Regulation is reproduced below for reference purposes:

“Unrealized mark-up/ interest to be kept in memorandum account and not to be credited to income account except when realized in cash. Unrealized mark-up/interest already taken to income account to be reversed and kept in the memorandum account.”

The Committee during its deliberations and conclusion has assumed that the loan was transferred from XYZ company to ABC company on the original agreed terms (as agreed between XYZ company and the bank), and the loan was not restructured/ re-scheduled, subsequent to its transfer to ABC company. However, for reference purposes the Committee would like to refer paragraph 3 of Regulation-8, which explains the basis for the recognition of suspended mark-up of the rescheduled/restructured loans/advances.

In the light of above, the Committee is of the view that suspended/un-realized mark-up of classified loans/advances should be recognized in accordance with the provisions of the Regulation, as issued by the SBP.

(February 01, 2017)

1.10 Break-Up value computation in case of Life Insurance Companies

Enquiry: We would like to draw attention to the ICAP’s Technical Release (TR) - 22 which provides professional guidance for the computation of book value per share of a company. As per the TR - 22, shareholders' equity is used as a basis to compute the book value per share and the components of shareholder's equity are stated to include the following:

- Paid up capital
- Revenue reserves and retained earnings (less accumulated losses if any).
- Capital reserves
- Surplus created as a result of revaluation of fixed assets.

In a peculiar situation of Life Insurance Companies operating in Pakistan, the insurer is also required by law (the Insurance Ordinance 2000 and SECP Insurance Rules, 2002) to maintain separate Statutory Funds in respect of assets, liabilities, equity and profit or loss attributable to the life insurance business. The statutory funds so maintained are presented separately in the financial statements from the shareholder's fund.

In order to comply with the solvency requirements under the applicable life insurance regulations, the life insurance companies are required to maintain required amount of equity balance (including capital contribution and retained earnings) in the statutory funds at all times. However, as the equity balance in the statutory fund is arrived at after deducting all liabilities including those pertaining to the policyholders, this equity by its nature and substance represents shareholder's interests in the statutory fund which is held to meet the solvency requirements. Therefore, for the purposes of determining the book value or breakup value per share of a life insurance company, the equity balance in the

statutory fund should be taken into account as otherwise the book value or the breakup value will not be reflective of the total shareholder's interest in the entity.

The requirements to maintain capital for regulatory, solvency and risk management purposes is not only limited to insurance companies but also is common with other entities operating in the financial services sector such as banks. The capital retained and held by banks, for instance, to comply with the capital adequacy requirements set by the State Bank of Pakistan or to maintain statutory reserves, is always taken as part of the shareholder's equity for all purposes.

It would be pertinent to mention that this conceptual position regarding the equity balance of statutory funds is also recognized under the draft insurance regulations issued by the SECP with the recommendation of ICAP. As per the draft regulations the equity of statutory funds and shareholder's funds is combined to state a single equity position in the balance sheet which is also in line with the IFRSs and Practices.

In view of the above, we request the Committee to confirm our understanding that the equity balance appearing in the statutory fund should be included for breakup value calculation.

Opinion: The life insurance companies are required to maintain statutory fund/(s) in accordance with the provisions of the Insurance Ordinance, 2000 and the related rules.

Further, the life insurance companies are also required to comply with the solvency requirements, and maintain an amount of the retained earnings in the above mentioned statutory fund/(s) at all times. Accordingly, the statutory fund/(s) of the insurance companies is an aggregation of the amount of the policyholder's liabilities and amount of retained earnings locked-in the statutory fund/(s), pursuant to the solvency requirements applicable to the life insurance companies.

The currently applicable law to the insurance companies, i.e. Insurance Ordinance 2000, does not provide for the aggregation of equity balance of the statutory fund/(s) with the shareholder's funds.

Presently, the life insurance companies are required to prepare their financial statements in accordance with the form/format prescribed by the SECP, in the SEC (Insurance) Rules 2002. In accordance with the above referred form/format of the financial statements, the statutory fund/(s) (containing the policyholder's liabilities and amount of locked-in retained earnings) is presented separately after the net shareholder's equity.

The Committee would also like to refer clause 14, 'Shareholder interests in statutory funds' contained in the Annexure II of the SEC (Insurance) Rules 2002, which states that:

(1) The shareholders' fund shall not recognise as an asset any interest in, entitlement to the assets of or capital transfer provided to any statutory fund.

(2) A capital transfer provided to a statutory fund by the shareholders' fund shall be recorded as a debit balance in shareholders' equity, clearly identified as capital contributed to statutory fund, and changes in the amount of capital contributed to statutory funds shall not pass through the profit and loss account but shall be recorded in the financial statements of the shareholders' fund as increases or decreases in that debit balance.

(3) No statutory fund shall recognise as a liability any amount due to the shareholder's fund consisting of a capital transfer received from a shareholder's fund, or retained profits attributable to shareholders, or any loan or advance, other than a current liability consisting of amounts due to the shareholder's fund on account of expenses due to be reimbursed to the shareholder's fund.

The Committee considers it pertinent to mention that the SECP has issued Insurance Rules 2017 and Insurance Accounting Regulations 2017 (Regulations 2017), on February 13, 2017. These rules and regulations supersede the SEC (Insurance) Rules 2002 and Insurance Rules, 2002. Further, the provision 6 of the Regulations 2017, applicable to the financial statements of life insurance companies, explain that the balances retained within the statutory funds over and above the insurance liabilities shall be treated as part of shareholder's equity, and the balances in Ledger C and D shall be included as part of the Shareholder's equity.

However, it is to be noted that the requirements of the Regulations 2017 are effective for the financial statements for the periods beginning on or after April 01, 2017. Consequently, the financial statements of the life insurance companies till the period ending March 31, 2017 should be prepared in accordance with the requirements of SEC (Insurance) Rules 2002.

In view of the above, the present applicable legal position makes it clear that shareholders' fund/equity do not include any balance that is held in the statutory fund either on account of capital contribution or retained earnings.

The Conceptual Framework for Financial Reporting defines equity as the residual interest in the assets of the entity after deducting all its liabilities. Based on this, the above referred locked-in amount of the retained earnings in the statutory fund/s is 'equity'; which will remain in the statutory fund/s to meet the solvency requirements and will not be available to the shareholders at the period end date.

However, it is to be noted that the provisions of the Companies Ordinance 1984, Insurance Ordinance, 2000 and SEC (Insurance) Rules 2002, regulations and directives will prevail over the IFRSs.

The Insurance Ordinance 2000, and related rules and guidelines do not provide the basis/mechanism for the computation of book/break-up value of life insurance companies. However, the Institute's Accounting Technical Release (TR)-22 (Revised 2002), '*Book Value per Share*', explains the basis for the computation of book/break-up value of shares. The relevant part of TR-22 is reproduced as under:

"Book value per share in the equity capital of the company is the amount each share is worth on the basis of carrying value per balance sheet, prepared in accordance with a framework of recognized accounting standards. Such standards provide that:-

(a) An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

(b) A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."

The computation of the book value per share under TR-22 is dependent on the recognition of the asset and liability in accordance with the framework of recognised accounting standards that provide the stated definitions.

However, TR-22 also outlines the basis for the computation of break-up value of share for the surplus on revaluation of fixed assets, as it is not a part of the equity on the balance sheet but is also not a liability. In case of revaluation surplus, TR-22 allows for the computation of an additional book value per share, though referring to the comparability purposes. The relevant part of TR-22 is reproduced as under:

"If the balance sheet of an entity includes balance of surplus on revaluation, the book value per share should be computed separately both, including and excluding such surplus, to enable comparability with those entities where fixed assets have not been revalued".

Conclusion: Based on the above, the Committee is of the view that the computation of break-up value per share of the life insurance company should be in accordance with the basis set out in TR-22. In view of the currently applicable financial reporting framework, in relation to the shareholders' equity required to be maintained in the statutory funds, the life insurance company's break-up value per share should be computed separately both, including and excluding such shareholders' equity.

(February 15, 2017)

1.11 Query on subsequent cost of Intangible Asset

Enquiry: Para 5.10 of AFRS for MSEs and SSEs allowed capitalization of expenditure on intangible asset subsequent to its completion, subject to certain conditions. With effect from July 01, 2015, Company is required to comply with Revised AFRS for SSEs, wherein no such para is included, however, para 3.6 in the Revised AFRS for SSEs provide guidance on capitalization of website costs.

Company owns the Job posting website, which is in operation for more than 5 years. Costs incurred during the operational period, subsequent to initial completion, meeting the criteria given under para 5.10 of AFRS for MSEs and SSEs (previously applicable), were also being capitalized by the Company.

a) Whether or not the guidance in para 3.6 of Revised AFRS for SSEs can be applied to capitalize the costs incurred on intangible asset subsequent to its completion?

b) If not allowed, should previously capitalized costs be de-recognized under the requirement of para 22.2b of Revised AFRS for SSEs?

Opinion: Section 3, *Intangible Assets*, of the Revised Accounting and Financial Reporting Standard for Small-Sized Entities (the Revised AFRS for SSEs), outlines the accounting and reporting requirements for the intangible assets. Paragraph 3.6 (as stated below) provides guidance for the accounting of website related costs:

3.6 “Website costs are categorized into five basic stages that are planning stage (stage 1), application and infrastructure development (stage 2), the graphical design development (stage 3), content development (stage 4) and operating (stage 5). Costs incurred in stage 1 and stage 5 are always expensed however costs incurred from stage 2 to 4 can be capitalized if it fulfills the criteria of development asset discussed in preceding paragraph, particularly (d) above”.

Considering the above requirements of paragraph 3.6, the Committee is of the view that the cost incurred subsequent to the initial recognition of the website can be capitalized, only, if it relates to the three eligible stages for capitalization i.e. application and infrastructure, graphical design and/ or content development. Costs incurred at planning and operating stages are always expensed.

In relation to second part of the query, the Company should consider the requirements mentioned in section 22, *Transition to the Accounting Standards for SSEs*, when it adopts the Revised AFRS for SSEs for the first time for the preparation of the financial statements.

Relevant paragraph of section 22 is reproduced below:

22.2 “An entity shall in its opening balance sheet as of its date of transition (beginning of the earliest period presented in financial statements) to this Standard:

- a. Recognize all assets and liabilities whose recognition is required by to this Standard;
- b. Not recognize items as assets or liabilities if to this Standard do not permit such recognition;
- c. Reclassify items that it recognized under its previous financial reporting framework as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under to this Standard; and
- d. Apply to this Standard in measuring all recognized assets and liabilities.

The financial effect of above actions should be reflected in opening balance sheet by adjusting the amount of retained earnings as at the date of transition.”

In accordance with the requirement (b) above, the Committee is of the view that previously recorded intangible asset should be re-assessed for recognition as per the criteria outlined in section 3 of the Revised AFRS for SSEs, and the items not fulfilling the criteria should be derecognized from the opening balance sheet and charged to the retained earnings, i.e., restatement would be required.

(March 14, 2017)

1.12 Foreign Currency Interest Free Sponsor's Loan

Enquiry: Pursuant to TR-32, the sponsors' interest free loans repayable at the discretion of borrower company are required to be classified as part of the 'equity' instead of a liability. One such loan from sponsors' received in foreign currency was disclosed as a liability and accordingly translated at year-end exchange rate every year. After change of its status as mentioned above, please let us know:

1. Whether the translation at the year-end exchange rates will still be required?
and
2. What should be the accounting treatment of net cumulative amount of translation differences included in carrying value of loan?

Please note that sponsor is a foreign parent company.

Opinion: The Committee considered your queries and its views are as follows:

1. According to paragraph 2.17 of the Technical Release (TR) - 32 '*Director's Loan*', a loan from a parent to a subsidiary in its capacity as shareholder, is in substance an additional contribution by the parent. Further, a loan from a parent to an entity which is agreed to be paid at the discretion of the entity does not pass the test of liability and shall be recorded as equity at face value and this is not subsequently re-measured.

In relation to the query, the interest free loan received from the parent and repayable at the discretion of the subsidiary under the initial agreed loan terms, shall be recorded at the exchange rate when loan was received, thereafter; translation of this amount is not required.

2. In the above scenario, the net cumulative amount of translation differences included in the carrying value of loan is required to be eliminated; consequently, related comparative amounts shall be restated.

TR-32 is applicable for preparation of financial statements for the period beginning on or after 1 January 2016. As required under paragraph 4.2 of TR - 32, the change in accounting policy resulting from the initial application of TR - 32 shall be accounted for retrospectively in accordance with IAS 8 '*Accounting Policies, Changes in Accounting Estimates and Errors*'.

(March 15, 2017)

1.13 Change of amortisation method of Intangible Asset

Enquiry: Para 3.4 of Revised AFRS for SSEs requires the Company to amortize the asset using straight line method, however our client, a Small Sized Company, was previously amortizing using written down value method of amortization.

a) Will it be mandatory for the Company to restate its opening balance sheet to account for the impact as required under para 22.2(d), or it may not be required?

Opinion: Paragraph 3.4 of Section 3 '*Intangible Assets*' and paragraph 22.2 of Section 22 '*Transition to the Accounting Standards for SSEs*', referred in your enquiry, are reproduced below for reference:

3.4 "An entity shall allocate the amortizable amount of an intangible asset over its useful life using straight line method. The amortization charge for each period shall be recognized as an expense, unless another section of this standard requires the cost to be recognized as part of the cost of an asset such as inventories or property, plant and equipment."

22.2 "An entity shall in its opening balance sheet as of its date of transition (beginning of the earliest period presented in financial statements) to this Standard:

a) Recognize all assets and liabilities whose recognition is required by to this Standard;

b) Not recognize items as assets or liabilities if to this Standard do not permit such recognition;

c) Reclassify items that it recognized under its previous financial reporting framework as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under to this Standard; and

d) **Apply to this Standard in measuring all recognized assets and liabilities.** (emphasis is ours)

The financial effect of above actions should be reflected in opening balance sheet by adjusting the amount of retained earnings as at the date of transition."

Measurement is defined in the Framework of the Revised AFRS for SSEs as follows:

"Measurement is the process of determining the monetary amounts at which an entity measures liabilities, assets, income and expenses in its financial statement. Measurement involves the selection of a basis of measurement. Two common bases are: Historical cost and Fair value.

The measurement base most commonly adopted by entities in preparing their financial statements is historical cost."

With regard to the enquiry, no change in the measurement basis of the intangible, i.e. historical cost shall be required on the adoption of AFRS for SSEs. Further, the

change in the amortization method from the reducing balance method to straight line method, mandated on the adoption of AFRS for SSEs, is a change in the accounting estimate. The effect of change in accounting estimate shall be recognised prospectively in accordance with paragraph 19.6 of Section 19 'Accounting Policies, Changes in Accounting Estimates and Errors'.

In view of the above, the Committee is of the view that restatement on account of this point is not required under paragraph 22.2(d) of Revised AFRS for SSEs.

(March 20, 2017)

1.14 Mark Up on Government Loans

Enquiry: 1. The Government of Pakistan and Privatization Commission (PC), vide decisions of the Cabinet Committee on Privatization (CCoP) and Economic Coordination Committee of the Cabinet (ECC) (decisions attached at Annexure 'a'), at different times, injected funds in an Public Limited Engineering Company (the Company) for relieving employees under Voluntary Separation Schemes/Compulsory Separation Schemes (VSS/CSS), shifting of machinery from B Works (BW) to K Works (KW) of the Company, bank loans of the Company taken over by the Government and amounts payable by the Company to different Government Departments like Customs, Railways and Karachi Port Trust.

2. Position of these loans / mark up as on 30.06.2015 is tabulated hereunder:-

	PC Loans	Govt. Loan	Rs. In Million Total
As per Company's Books Principal Loan	481	1,309	1,791
As Per Govt./ PC Stand Principal Loan	613	1,309	1,922
Difference	131	-	131
Mark Up Claim of Govt.	1,295	2,801	4,097
Total Claim of Govt.	1,908	4,111	6,019

First time in the year 2005, the PC and Government of Pakistan had claimed mark up on the loans amounting to Rs. 2,664 million (up to 31.12.2010) and PC also confirm the loan in excess of Rs. 131 million being the amount of additional gratuities paid by the PC on behalf of the Company. Thus Government of Pakistan and PC as now claimed Rs. 6,019 million up to 30.06.2015 (Including principal loan of Rs. 1,791 million and additional gratuities of Rs. 131 million and mark up of Rs. 4,097 million up to 30.06.2015) instead of Rs. 1,791 million. A net difference of Rs. 4,228 million compared with the Company's stance.

It is pertinent to mention that additional gratuities (valuing Rs. 131 million) were paid by Privatization Commission as per the agreement between the Company CBA and Privatization Commission without the consent of the Company management; hence this liability is not agreed by the Company.

According to the CCoP decision, dated May 30, 1994 these liabilities will be settled against the proceeds from disposal of BW Land (held for sale) and surplus land of KW, if needed. There is no fixed repayment schedule or tenure for repayment of these liabilities.

3. The management of the Company had handed over the title documents of the BW Land to the PC for disposal in the year 1994 and had PC disposed off the land at that time, no issue of interest would have arisen.

4. Several meetings for the reconciliation of these loans/mark-up have been conducted between Ministry of Finance, Privatization Commission, Ministry of Industries & Production and Committee of Directors of the Company constituted by the Board of Directors of the Company. All these meeting concluded with-out any decision with respect to the reconciliation of the loan liabilities and calculation of payment of interest on Government loans.

5. PC and Finance Division have claimed additional mark up on the above loans, however, the Board of Directors and the management of the Company do not agree with the additional liabilities claimed hence the payment of interest is disputed as there had never been any agreement in this regard. The loan liabilities were picked up by the Government so that the Company could be privatized. It may also be noted that many public sector entities which were provided such type of reliefs by the Government of Pakistan have never been asked to make any payment in respect of such reliefs.

6. The Board of Directors and management of the Company is willing to repay all the outstanding liabilities, which the Company is legally liable through disposal proceeds of BW Land and surplus land of KW, if needed. However, it is their considered opinion that the Company is not liable to pay any interest on these loans in the absence of any agreement. The management of the Company obtained legal opinion on the issue of interest on Government of Pakistan/ PC loans from the three firms of repute on 19.02.2016, 22.02.2011 and 10.10.2007.

The legal advisors are of the firm opinion that in cases where there is no mention of any mark-up or interest, and in the absence of any agreement, implied or explicit, for payment of markup, charging of the same is clearly not permitted under the law.

7. No SRO, notification or documentation was provided by the Ministry of Finance to substantiate their view point on the issue of levy of mark up on Government/ PC loans.

8. The management is confident that the ultimate outcome of the matter will result in favor of the Company and hence no provision has been made in the financial statements in respect of additional loan and markup claimed by the Government of Pakistan /PC.

9. The purpose of writing to ICAP is that certain documents reflect the provision of mark up on specific loans whereas other loans documents do not speak about the levy of mark up. As per IAS, SECP and Tax Laws the accounts of the Company

should reflect the actual and real profit/ loss of the business. At present we are not making any provision of mark up on Government of Pakistan /PC loans.

10. ICAP is requested to kindly advise us on the following issues:

- a. Whether the Company should start accruing mark up on these loans and at what rates on the loans which does not specify the rate of mark up.
- b. Whether the Company should consider the additional gratuity of Rs. 131 million as liability?
- c. Will the reclassification of financial statement would be required if the answer of 'a' and 'b' is "yes".

Opinion: The Committee would like to refer following definitions of IAS 37 '*Provisions, Contingent Liabilities and Contingent Assets*':

A ***provision*** is a liability of uncertain timing or amount.

A ***liability*** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

A ***contingent liability*** is: (underline is ours)

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

- (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
- (ii) the amount of the obligation cannot be measured with sufficient reliability.

In accordance with IAS 37, the mere existence of a present obligation as a result of a past event is not a sufficient basis on which to recognise a provision. In addition, the entity needs to consider whether it is probable that the obligating event will result in an outflow of resources. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility is remote. Such an assessment involves judgment by management on a case-to-case basis, taking into account the documentary evidence, and past experience relating to the pattern of claims arising from any similar events and the circumstances surrounding the particular obligating event.

Accordingly, management needs to assess whether there is a present obligation and a probability that an outflow of resources embodying economic benefits is required to settle the obligations. Based on such assessment, if provision/ accrual is required to be made then it should be recorded.

In view of the above conditions and details provided in the enquiry, the Committee is of the view that the management of the company needs to determine whether a present obligation exists at the end of the reporting period taking into account all the available evidences, including, the opinion of legal experts. Where there is a probability that a present obligation exists at the end of the reporting period, the provision should be recognized. Contrary to this will require an entity to disclose a contingent liability.

Further, the Committee is also of the view that if in management judgment accrual of markup is required on loans, then, restatement will be required as per IAS 8 '*Accounting Policies, Changes in Accounting Estimates and Errors*'.

(March 28, 2017)

1.15 Applicability of IAS 20 "Accounting for Government Grants and Disclosure of Government Assistance" for loans obtained from the Government of Sindh at lower interest rate

Enquiry: A public listed Gas Company (the Company) is engaged in providing essential services of transmission and distribution of natural gas in the provinces of Sindh and Baluchistan. Being the only transmission and distribution company in both provinces, the Company takes various projects for laying of pipelines including those ones which are initiated based on instructions received from the Government of Sindh (GoS) which provide financing facility to the Company at the interest rate which is lower than market interest rate, due to which requirements of paragraphs 12 of IAS 20 "Accounting for Government Grant and Disclosure for Government Assistance" are triggered with regard to recognition of government grant and its amortization. In ensuing paragraphs, we have provided background facts and described three possible options for accounting of such government grant and request your guidance as to which of these options are appropriate in terms IAS 20.

Regulatory Regime of the company

The Company is regulated by the Oil and Gas Regulatory Authority (OGRA) which is statutory body created under the Oil and Gas Regulatory Authority Ordinance, 2002 (the Ordinance) with a mandate to regulate licensees engaged in the transmission, distribution and sale of natural gas. Under the provision of license given by OGRA, the Company is provided a minimum annual return (ROA) of 17% per annum of the net operating fixed assets (net of deferred credit) for the year excluding financial and other non-operating income and taxation. The determination of annual required return is reviewed by OGRA under the terms of License for transmission, distribution and sale of natural gas, along with the targets and parameters set by OGRA. Income earned in excess/ short of the above guaranteed return is payable to/ recoverable from the Government of Pakistan (GOP) and is adjusted from/ to the Gas Development Surcharge (GDS) balance payable to / receivable from GOP.

Details of loans obtained from the Government of Sindh (GOS) at lower interest rate, and the related accounting requirements in light of the approved accounting standards as applicable in Pakistan.

The Government of Sindh (GOS) has provided unsecured loans to the Company at interest rate of 2-4% per annum, against a market rate (9% to 13.5%), for period of 12 years under the agreement for supply of gas to the areas in the Sindh province only subject to prior approval from the competent authority of the province.

In the previous years, the Company did not recognize difference between interest rate charged by GoS and prevailing market interest rate, as government grant, as impact of amounts was not considered material and no new loan was obtained since 2013. However, the Company is currently expecting more loans in future and management now considers that cumulative impact owing to changes in financial position may become significant.

Management has evaluated the accounting treatment in the light of accounting standards and prevalent industry practice, and has identified three possible options for accounting the government grant arising from GOS Loans explained below:

1 - Amortization of Grant over the Useful Life of the Asset

If the requirements of IAS 20 are followed as per the agreements, the Company would have to incorporate the following impacts in its books of accounts:

- GoS loans will be discounted at market rate and any difference between the loan amount received and the discounted loan amount will be recognized as a government grant (credit).
- GoS loans will be recognized at present value i.e. discounted loan amounts.
- Interest expenses on the discounted loans will be recognized at market rate, resulting in increase in financial charges every year, except in case of initial years wherein interest expenses will be capitalized to asset for which the loan has been provided by GOS.
- Government grant (deferred credit) will be amortized over the period of useful life of asset, which is considered 20 years, as income in profit and loss account.

The issue with this treatment is that actually there is no cost to the Company, as the assets also get financed through revenue requirements under cost plus formula of 17% return on operating fixed assets except for those assets which may be disallowed by OGRA due to the reason that such projects are not meeting per customer cost criteria being not feasible. In the past, OGRA has been allowing ROA on all such projects, and only in the FY 2013, 14, 15 and 16, OGRA has disallowed certain projects on the basis that such projects were not feasible:

2- Government Grant be amortized over the repayment period of loan

Loans are discounted at market rate and any difference between the loan amount received and the discounted loan amount is recognized as a government grant which is amortized over the repayment period of the loan instead of useful life of the asset.

3- Matching the Government Grant with related cost

As per paragraph 12 of IAS 20 "Accounting for Government Grants and Disclosure of Government Assistance":

"Government grants shall be recognized in profit or loss on a systematic basis over the periods in which the entity recognizes as expenses the related costs for which the grants are intended to compensate" (emphasis is ours)

Since there are no "related costs" as all costs of assets acquired or constructed by Company are recovered through cost plus return of 17% on operating fixed assets as revenue of the Company through OGRA except for those assets which are disallowed by OGRA from time to time due to the reason that such projects are considered unviable. It can be argued that such government grant is provided to compensate the Company for any unviable projects which are disallowed by OGRA. Therefore, a case can be made to recognize the government grant in profit and loss account at time of recognizing the impairment loss related to unviable projects (if needed) and any remaining unamortized grant in excess of expected impairment to be transferred to profit and loss account immediately.

Seeking appropriate opinion from ICAP for IAS 20

We request ICAP to kindly advise us as to which of the three options described above reflect right accounting treatment in accordance with the approved accounting standards as applicable in Pakistan.

Opinion: In accordance with paragraph 10A of IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, the benefit of the government loan at a below-market rate of interest is treated as a government grant, and requires the entity to measure and record the benefit of the below-market rate of interest in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*. Consequently, the government grant is measured as the difference between total loan amount received and the fair value of the loan on initial recognition.

In addition, IAS 20 requires "the entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of loan is intended to compensate". In the enquired scenario, the benefit available to the entity is reflected by the borrowing costs compensated through the loan at below-market rate of interest.

Further, the Committee understands that the borrowing costs (including the imputed interest originating on the below-market rate of interest loan) eligible for capitalization will be included in the cost of the qualifying asset, and subsequently, charged to the profit or loss through yearly depreciation charge. In the ensuing periods, the borrowing costs will be charged to the profit or loss, consequent to the completion of the qualifying asset.

IAS 20, paragraph 12 outlines, the principle for the recognition of grant in the profit or loss, reproduced as under:

“Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which grant was intended to compensate.” (Underline is ours)

IAS 20 also envisages that in most cases, the periods over which an entity recognises the costs or expenses related to the government grant are readily ascertainable and thus grant in recognition of specific expenses are recognised as income in the same period as the relevant expense. Furthermore, paragraph 19, clarifies that it may be appropriate to allocate part of the grant on one basis and part on another.

In the enquired scenario, the Committee is of the view that the recognition of government grant in the profit or loss shall be on the basis of pattern of recognition, as expenses, the costs the grant intends to compensate. As explained above, the borrowing costs related to the below-market interest loan shall be charged to the profit or loss through:

- (a) depreciation charge (represents the capitalized borrowing costs); and
- (b) the finance costs.

Further, in accordance with IAS 20, the recognition of grant in the profit or loss shall represent an appropriate form of matching with the recognition of related expenses for which the grant intends to compensate.

Based on the above, the Committee is of the view that the accounting treatment of the government grant in the enquired scenario, shall be as follows:

- a) Government grant related to the borrowing costs capitalized as cost of the qualifying asset, amortized over the period of useful life of the asset, i.e. 20 years in the enquired scenario; and
- b) Government grant related to the borrowing costs charged to profit or loss as finance costs, amortized over the loan term, i.e. 10 years reduced by the years in which borrowing costs is capitalized, a) above, in the enquired scenario.

In this way, the benefit of the grant is recognized on a systematic basis because the entity recognises, as expenses, the costs the grant is intended to compensate.

(March 28, 2017)

1.16 Reclassification of Items

Enquiry: Please advise if trade receivables are netted with advances from customers and reported as a single net balance in prior year because it pertains to two different branches of same customer and customer used to pay on branch behalf and sometimes branches pays themselves (they have legally enforceable right to setoff) and in current year these are reported separately as an asset and liability on the balance sheet and consequently comparative figures have been restated/ reclassified. In the prior year the amount was off-set as:

- a) the customer paid extra amount at one branch to settle amount owed by them at another branch.
- b) the net credit balance from the customer, if any, was presented as a liability.
- c) advance amount (if a receivable of equal or more exists with another branch) did not entitle the customer to further goods. Further, customer is only entitled to future supply of good for net credit balance only.

Please advise whether the change in presentation is a reclassification or not? It involves material amounts and also offsetting of assets and liabilities last time was in accordance with IFRS. As affirmative reply means reclassification disclosure has to be presented (if material).

Opinion: In context of the information submitted by the enquirer, we understand that the company settled the trade receivable and customer advance balances on a net basis. Consequently, the amount of net receivable is a financial asset, while any net credit balance, being a customer advance, is a financial liability as cash will be refunded to customer.

In accordance with IAS 1, *Presentation of Financial Statements*, the assets and liabilities can be offset, if permitted or required by International Financial Reporting Standard.

Offsetting, in accounting, is the presentation of financial assets and financial liabilities on a net basis in the financial statements. The offsetting of financial instruments is required under IAS 32, *Financial Instruments: Presentation*, and the underlying principle outlined in paragraph 42 of IAS 32 is mentioned below: (Emphasis is ours)

“A financial asset and a financial liability **shall be offset** and the net amount presented in the statement of financial position when, and only when, an entity:

- (a) currently has a legally enforceable right to set off the recognised amounts; and
- (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.”

Further, Paragraph 43 of IAS 32, clarifies that “When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, **only a single financial asset or financial liability**”. (Emphasis is ours)

In view of the above discussion, offsetting is required when there is both a right and intention to offset because doing so reflects an entity’s expected future cash flows from settling two or more financial instruments. The view is that offsetting in such situations, in effect, represents in the balance sheet that the entity has a single financial asset or financial liability. In other circumstances and conditions, the financial assets and liabilities are presented separately at their gross amounts in accordance with their characteristics as resources or obligations of the entity.

IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, defines accounting policies as specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. Further, the

change in accounting policy requires restatement. However, application of accounting policy for new transactions, events or conditions that differ in substance from those previously occurring is not a change in the accounting policy.

IAS 1, *Presentation of Financial Statements*, requires consistent presentation and classification of items in the financial statements from one period to the next unless a change is justified either by a change in circumstances or a requirement of a new IFRS. Further, the entity shall reclassify the comparative amounts in case of change in the presentation or classification of items, unless reclassification is impracticable.

Based on the information contained in the enquiry, the Committee understands that off-setting of financial assets (trade debtor) and financial liability (customer advance) relating to the same counterparty, in the prior period/s, must be on the basis of the above principle of IAS 32. Any change in the presentation can only be made if there is change in the terms and conditions which don't meet the off-setting criteria discussed in the preceding paragraphs.

(March 27, 2017)

1.17 Query on Liquidated Damages

Enquiry: Following are the two enquiries pertaining to liquidated damages:

Query 1:

A company is engaged in telecommunication. It awards contracts for jobs of capital nature which involve purchase of equipment and its installation. The equipment is normally handed over to the company after the trial runs and final acceptance. The equipment is normally capitalised once the final acceptance is signed off. The price of the equipment is governed mainly in line with the price book agreed with the vendor and the company's parent company group frame work agreement.

The purchase agreements generally contain following type of penalties:

- Penalties for delayed installation.
- Actual revenue loss during installation prior to final acceptance based on estimate.
- Actual revenue loss after acceptance and capitalization of the equipment caused by any issue relating to equipment.

IFRS is not very clear about the treatment of these damages/ penalties. We will appreciate if guidance is provided, how each such type of penalties should be treated. Company is currently booking all the above as other revenue.

Query 2:

A telecommunication company has outsourced its network maintenance job. The maintenance contract has performance bench marks. The contract contains bonus or additional payment for performance better than the set bench marks and penalties for the performance below the set targets.

The company is currently charging the normal payment and additional bonus to cost and booking penalties for under performance as other income. Is the mentioned treatment correct? Will the situation /treatment would be different if the underperformance penalty is calculated based on the actual revenue loss resulting from the underperformance.

Opinion: Committees response to the queries is as follows:

Query 1:

The Committee would like to refer following paragraphs of IAS 16 '*Property plant & Equipment*' (underline is ours):

“15 An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.”

“**Cost** as defined in IAS 16 is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, e.g. IFRS 2, Share-based Payment.”

The paras of IAS 16 relating to the elements of cost are reproduced as under:

“16 The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.”

“17 Examples of directly attributable costs are:

- (a) costs of employee benefits (as defined in IAS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;
- (b) costs of site preparation;
- (c) initial delivery and handling costs;
- (d) installation and assembly costs;
- (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to

that location and condition (such as samples produced when testing equipment); and
(f) Professional fees.”

“21 Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognized in profit or loss and included in their respective classifications of income and expense.”

The Committee’s response to the enquired scenarios is as follows:

a) Penalties/ liquidated damages for delayed installation

Purchasing fixed assets does not give rise to income. Therefore, in the absence of specific reference to compensating for losses in a liquidated damage clause, the liquidated damages received are deducted from the cost of the related assets.

The rationale for this approach is consistent with the conclusion that, rather than damages for delay, the contract provides for an additional payment in the event of early completion.

For example, if rather than a Rs. 100 penalty for late delivery on a Rs. 1,000 contract after 1 January 200X, as the contract had a value of Rs. 900 but provided for an additional payment of Rs. 100 for an early completion before 1 January 200X. Therefore, the cost of the asset is the total price paid to acquire it, including the premium for early completion (i.e., Rs. 1,000 if finished before 1 January 200X and Rs. 900 if finished after 1 January 200X). This gives the same result as with liquidated damages.

b) Penalties for actual revenue loss during installation prior to final acceptance based on estimate

However, when the liquidated damages clause in a contract refers to compensating the affected party for any revenue lost or reimbursement of specific costs incurred because of delay in the completion of the project, then recognizing as revenue or deducting against specifically reimbursed costs is more consistent with the purpose of the liquidated damages clause.

c) Penalties for actual revenue loss after acceptance and capitalization of the equipment caused by any issue relating to equipment

At the date of acceptance, the Company has determined that the asset capable of operating in the manner intended by management and accordingly has also

estimated the amount payable to vendor. If, however, this estimate is revised, subsequent to the yearend, the effect of revision in amount payable to vendor will be taken to profit and loss account, as an adjustment in estimate, in accordance with IAS 8.

Query 2:

The Committee is of the view that additional payment made by the Company in case of better performance than the set benchmark, should be part of the maintenance cost. Further, the penalties imposed on the vendor due to performance below the set benchmark should be adjusted against the maintenance cost as these refers the compensation for the below standard maintenance job.

(May 19, 2017)

1.18 Consolidation of Subsidiary - Private Brokerage Company

Enquiry: A listed modaraba has 100% wholly owned subsidiary which is a private brokerage company.

The subsidiary (incorporated in Dec 2015) has not yet commenced its operations as Trading Right Entitlement Certificate (which is in the name of Modaraba) is pending transfer by PSX to brokerage subsidiary.

The question is that whether:

1. The subsidiary needs to be consolidated on each reporting period? i.e. Quarterly, Half yearly and annually.
2. Either whole set of financial statements will be made? i.e. BS, P&L, CF, SOCE, Notes for each reporting period or any of these can be omitted?

Please note that the subsidiary is a private brokerage company duly incorporated in Dec 2015 and has not yet commenced its operations due to pending transfer of TREC by PSX.

Opinion: The Committee understands that the Modaraba is registered under Modaraba Companies and Modaraba (Floatation and Control) Ordinance 1980 (Modaraba Ordinance).

The financial statements of the Modaraba are prepared in accordance with the approved accounting standards as applicable in Pakistan and the requirements of the Modaraba Ordinance, Modaraba Rules 1981 and Prudential Regulations for Modaraba. Further, the Modaraba Ordinance does not contain a provision for the preparation of consolidated financial statements.

However, section 503 of the Companies Ordinance 1984 (the Companies Ordinance) explains that the provisions and requirements of the Companies Ordinance are applicable to companies governed by special enactments including modarabas. The relevant clause of section 503 of the Companies Ordinance is reproduced as under:

“503. Application of Ordinance to companies governed by special enactments.- (1) The provisions of this Ordinance shall apply-

(c) to modaraba companies and modarabas, except in so far as the said provisions are inconsistent with the provisions of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 (XXXI of 1980);.....”

The Committee would also like to refer following requirements of section 237 of the Companies Ordinance and paragraph 4 of IFRS 10 ‘*Consolidated Financial Statements*’, which are self-explanatory: (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 requirements of the Fourth schedule and International Accounting Standards notified under sub-section (3) of section 234.

(3) Every auditor of a holding company appointed under section 252 shall also report on consolidated financial statements and exercise all such powers and duties as are vested in him under section 255.

(4) All interim financial statements of a subsidiary as required under sub-section (3) shall be reviewed by the auditors of that subsidiary appointed under section 252 who shall report on such financial statements in the prescribed form.

IFRS 10

4. An entity that is a parent shall present consolidated financial statements. This IFRS applies to all entities, except as follows (we understand that these exceptions are not applicable in your case):

(a) 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 financial statements that are available for public use and

comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this IFRS.

Based on the information provided to the Committee, it understands that your Modaraba is not an investment entity, and the exemption given for the requirements of section 237 of the Companies Ordinance through SECP's SRO 56(1)/2016 and IFRS 10 are not applicable.

Your attention is also drawn to the requirements of IAS 34 '*Interim Financial Reporting*': (underline is ours)

IAS 34

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements (as described in IAS 1 *Presentation of Financial Statements* (as revised in 2007)) or a set of condensed financial statements (as described in this Standard) for an interim period.

Conclusion:

Based on above, the Committee's view to your queries is as follows:

1. A subsidiary of listed Modaraba should be consolidated at each reporting period despite the fact that it has not yet commenced the operations. Accordingly, the consolidated financial statements shall be prepared at the interim period/s in accordance with the requirements of the Companies Ordinance.
2. Complete set of financial statements as defined under paragraph 10 of IAS 1, should be made annually, whereas, for interim financial reporting, either a complete set of financial statements (as described in IAS 1) or a condensed set of financial statements can be made (as described in IAS 34).

IAS 34 defines the minimum content of an interim financial report which includes condensed financial statements and selected explanatory notes. IAS 34 does not prohibit or discourage an entity from publishing a complete set of financial statements in its interim financial report, nor does it prohibit or discourage an entity from including in condensed interim financial statements more than the minimum line items or selected explanatory notes as set out in this Standard.

(May 25, 2017)

1.19 Issue of booking the principal amount for IPPs

Enquiry: IPPs are regulated under NEPRA ACT and the Regulator has determined the Tariffs of the IPPs after careful scrutiny under the 2002 GOP Power Generation Policy.

However, the IPPs are under criticism for showing much higher profits, the major reason why IPPs are showing much higher profits is due to the accounting treatment of the long term loan Principal payment received by the IPPs which is shown under the head of revenue. Practically, this not an income for the IPPs since this whole amount is repaid to the Lenders by decreasing the liability in the books. On the other hand, the revenue item remains intact in the books without any corresponding expense entry. This treatment is as per the standards.

However, the general public the politicians, the bureaucrats do not fully understand this technical aspect and, IPPs are victimized unnecessarily in the media. As all IPPs have an annuity structure with the lenders where the principal repayments amount increases with time, the profits continue to increase in the books. The scale of this difference can be judged from the fact that the actual profit amount is more than doubled when the loan repayment amount is booked revenue head.

We would request ICAP to:

- (a) Find some practical accounting solution for this item (past and future Treatments) without going into the leasing structure which has its own drawbacks for the moment.
- (b) Notify such Change/ solution to us and to the audit companies in Pakistan for their annual review purposes.

Opinion: Power sector in Pakistan is regulated by National Electric Power Regulatory Authority (NEPRA). The Committee understands that the roles and responsibilities of the NEPRA include determination of tariff for generation, transmission and distribution of electric power, under the power policies issued by the Government of Pakistan from time to time. The tariff determined by the NEPRA during the initial years of operation of a power generation company also includes the recovery of principle amount of the loans obtained by that power generation company to finance its project, as per the applicable power policy. Such tariff should be used to record revenue of the power generation companies in accordance with IAS 18 'Revenue'.

The Committee would like to mention that the financial statements of the power sector companies are prepared in accordance with the approved accounting standards as applicable in Pakistan which generally, comprise of International Financial Reporting Standards (IFRSs) as notified under the Companies Ordinance, 1984, (the Ordinance), the provisions and directives issued under the Ordinance. In case the requirements differ, the provisions or directives of the Ordinance prevail.

SECP vide S.R.O. 24(1)/2012 dated January 16, 2012 has granted waiver to the companies, including the power sector companies from the requirements of IFRIC 4 'Determining whether an arrangement contains a lease' and IFRIC 12 'Service Concession Arrangements'. However, the SECP made it mandatory for such companies to disclose the impact on the financial results of the application of the IFRIC 4 and IFRIC 12. It is relevant to note that the SECP provided above mentioned exemptions to the power sector companies on the request of IPPs.

Based on the above discussion and consideration of the enquired scenario, the Committee is of the view that the accounting treatments are prescribed in IFRIC 4

and IFRIC 12 and the solution lies in the application of these IFRICs, in accordance with company's arrangement. If a power sector company chooses to apply any of these IFRICs, it can do so.

(May 29, 2017)

AUDITING

2.1 Conflict of Interest

Enquiry: Our firm has been appointed by Communication & Works Department, Government of the Punjab (GOPb) to carry out the assignment relating to M/s. ABC Private Limited (“the company”), which has undertaken a road project on Build Operate Transfer (BOT) basis, for the following scope of work:

- a) to review and certify, monthly statement of transactions undertaken from the project maintenance/escrow account in accordance with the provisions of the agreement related to the project.*
- b) To audit and certify, the basis and computation of the claim by the RBOC related to compensation for cost resulting from changes in design in accordance with the provisions of the agreement related to the project.*
- c) To audit and certify, the basis and computation of the claim by the RBOC or GOPb related to request for the revision of toll rates and for an appropriate amendment in the toll escalation rules and where necessary in accordance with the provisions of the agreement related to the project.*
- d) To audit and verify the claim of loss by RBOC and provide amount due and payable with respect of the claim in accordance with the provisions of the agreement related to the project.*
- e) To audit and verify the basis of computation of any other claims under this agreement filed by RBOC or the GOPb as defined in clause 33.2.1 of the agreement related to the project.*
- f) To review any and all audit reports issued by the RBOC auditor for correctness and compliance in accordance with the provisions of the agreement related to the project.*

The period relating to the above assignment is from October, 2003 to September, 2028. The financial statements of the company are audited by another firm M/s. XYZ & Co. Chartered Accountants. Our partners, Mr. G & Mr. F were partners of M/s. XYZ & Co. Chartered Accountants till May 2006. During the period, the financial statements of the company for the half year ended Dec 31, 2004 & year ended June 30 2005 were audited by M/s. XYZ & Co. Chartered Accountants as per accounts provided by M/s. ABC Private Limited and the audit reports were signed by Mr. G.

In the light of the above, kindly give us Committee’s opinion if there is a conflict of interest under either of the following circumstances:

- i. Partner who remained the partners in M/s. XYZ & Co. is engagement partner of the assignment.
- ii. Another partner of M/s. XYZ & Co. who never remained part of M/s. XYZ & Co. is engagement partner of the assignment.

Opinion: We would like to refer revised ICAP Code of Ethics for Chartered Accountants (the Code) which institutes the fundamental principles of professional ethics and provides a conceptual framework for applying those principles. One of the basic elements of the framework is ‘Independence’. It is important to note that independence of mind and in appearance is necessary to enable the practicing chartered accountants to enable them to express a conclusion, without bias, conflict of interest or undue influence.

Practicing chartered accountants are expected to provide an assurance and variety of non-assurance services that are consistent with their skills and expertise. While rendering other services to an audit client, practicing chartered accountants are required to apply the conceptual framework to identify threats to compliance with the fundamental principles and assess their significance and implication.

The onus of evaluation of such threats to compliance with the fundamental principles rests on the practicing chartered accountants and they should consider qualitative as well as quantitative factors while performing such evaluation. Such obligation on the part of a practicing chartered accountant becomes more critical in a situation where the applicable guidelines or regulations do not clearly prohibit any specific service. Relationships should be avoided which allow prejudice, bias or influences of others to override objectivity.

In this connection, the Committee would also like to refer the following paras of section 220 ‘Conflict of Interest’ of the Code which states:

“220.1 A chartered accountant may be faced with a conflict of interest when undertaking a professional activity. A conflict of interest creates a threat to objectivity and may create threats to the other fundamental principles. Such threats may be created when:

- The chartered accountant provides a professional service related to a particular matter for two or more clients whose interests with respect to that matter are in conflict; or
- The interests of the chartered accountant with respect to a particular matter and the interests of the client for whom the chartered accountant provides a professional service related to that matter are in conflict. (Underline is ours)

A chartered accountant shall not allow a conflict of interest to compromise professional or business judgment. When the professional service is an assurance service, compliance with the fundamental principle of objectivity also requires being independent of assurance clients in accordance with Sections 290 or 291 as appropriate.”

“220.3 When identifying and evaluating the interests and relationships that might create a conflict of interest and implementing safeguards, when necessary, to eliminate or reduce any threat to compliance with the fundamental principles to an acceptable level, a chartered accountant in practice shall exercise professional judgment and take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the chartered accountant at the time, would be likely to

conclude that compliance with the fundamental principles is not compromised.”

“220.5 If the threat created by a conflict of interest is not at an acceptable level, the chartered accountant in practice shall apply safeguards to eliminate the threat or reduce it to an acceptable level. If safeguards cannot reduce the threat to an acceptable level, the chartered accountant shall decline to perform or shall discontinue professional services that would result in the conflict of interest; or shall terminate relevant relationships or dispose of relevant interests to eliminate the threat or reduce it to an acceptable level.”

“220.6 Before accepting a new client relationship, engagement, or business relationship, a chartered accountant in practice shall take reasonable steps to identify circumstances that might create a conflict of interest, including identification of:

- The nature of the relevant interests and relationships between the parties involved; and
- The nature of the service and its implication for relevant parties.

The nature of the services and the relevant interests and relationships may change during the course of the engagement. This is particularly true when a chartered accountant is asked to conduct an engagement in a situation that may become adversarial, even though the parties who engage the chartered accountant may not initially be involved in a dispute. The chartered accountant shall remain alert to such changes for the purpose of identifying circumstances that might create a conflict of interest.”

In the light of above, the Committee views on your queries are as follows:

1. To avoid a risk of conflict of interest, the Code requires that safeguards should be applied, when necessary, to eliminate or reduce any threat to compliance with the fundamental principles to an acceptable level. In Committee’s view, there is a self-review threat for partners, Mr. G & Mr. F as their previous firm has done external audit for the half year ended 31 December, 2004 and year ended 30 June, 2005. Therefore, they should not act as engagement partners or technical/ quality review partners for those years.

The Committee is also of the view that it is the duty of the incoming auditor to guard against independence/ familiarity threats, if any, including the cooling-off period of the outgoing partner(s). Section 290.149 of the Code requires cooling off period of two years for clients who are public interest entities. For private companies no such requirement is given. However, firms may have longer cooling-off periods as per their respective partnership arrangements

2. No apparent conflict of interest arises in the inquired situation.

(November 25, 2016)

2.2 Performing accounting and audit of Public Interest Entity

Enquiry: The Public Interest Entity (PIE) floated a tender inviting bid from CA firms for accounting and audit work. There was no mention in the tender document that firms could apply in consortium/ JV for the assignment. Moreover, as per text of the terms of reference of the bid only technically and financially qualified firm (*singular connotation*) is to be selected for the above mentioned services. Keeping in view the above scenario, we request to provide technical advice on the following matters:

1. For PIE, is a firm allowed to undertake both accounting work and audit of financial statements.
2. If not allowed, then can conflict of interest be avoided in either of the following circumstances:
 - a. In response to the tender, one firm submits bid for the providing both accounting and auditing work in its own name. To avoid conflict of interest it mentions in the bid documents that it has entered into an agreement (*internal agreement*) with another firm that either of the assignments shall be performed by one of them. Although, the responsibility for the execution of both assignments would rest on the applicant firm.
 - b. Two firms submit one bid by forming JV/ consortium for both the assignments together and enter into agreement (*internal agreement*) between themselves defining the allocation of the work. Can conflict of interest be avoided under such an arrangement, whereas submission of joint bid implies that both the firms shall be jointly responsible for both the assignments.

It is requested to kindly provide technical guidance on each of the scenario stated above.

Opinion: The ICAP revised Code of Ethics for Chartered Accountants 2015 (the Code) provides a conceptual framework for applying fundamental principles of professional ethics, one of which is 'Independence'.

A practicing chartered accountant is required to apply the conceptual framework to identify threats to compliance with the fundamental principles and assess their significance and implication. The responsibility of evaluation of such threats to compliance with the fundamental principles rests on the practicing chartered accountants and they should consider qualitative as well as quantitative factors while performing such evaluation. In case where practicing chartered accountants render such services which may coincide with management functions and management decision making, the threat of "Self Review" could exist.

In this connection the Committee would also like to refer the paragraphs 290.164 - 290.167 of the Code which states:

Preparing Accounting Records and Financial Statements

General Provisions

“290.164 Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework. These responsibilities include:

- Originating or changing journal entries, or determining the account classifications of transactions; and
- Preparing or changing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).”

“290.165 Providing an audit client with accounting and bookkeeping services, such as preparing accounting records or financial statements, creates a self-review threat when the firm subsequently audits the financial statements.”

Para 290.166 - 67 describes the activities that are considered to be a normal part of the audit process and do not, generally, create threats to independence.

Para 290.168 of the Code allows the audit firm that may provide accounting related services only in case of audit clients that are not public interest entities, subject to applying certain safeguards. Such services are considered to be of a routine or mechanical nature, so long as any self-review threat created is reduced to an acceptable level. This relaxation does not exist for audit clients that are public interest entities.

In the light of above, the Committee views on your queries are as follows:

1. Audit firm is not allowed to undertake both accounting work and audit of financial statements of public interest entities simultaneously.
2. The independence of mind and in appearance is necessary to enable the practicing chartered accountants to express a conclusion, without bias, conflict of interest or undue influence. Therefore, in Committee’s view, the fundamental principle of ‘Independence’ will be impaired in both the given circumstances

(December 15, 2016)

2.3 Charging of minimum audit fee for closed operation client

Enquiry: M/s PQR Textile Mills Limited was public listed company and stands de-listed from Pakistan Stock Exchange Limited on April 28, 2016. The operations of the company were remained closed from October-2008 to April-2014 and the operations were started again from May 2013 to March 2014. From April 2014 till date, the operations are still closed. In the meanwhile, we have changed the auditors of the company for the year June 30, 2016 due to ICAP QCR requirement.

According to clause 5 of revised ATR -14 of ICAP, the minimum audit fee in case of sickness of the project or closed operation or discontinuation of business, shall be restricted to Rs. 75,000 per annum.

According to clause 7 of same ATR, the minimum audit fee determined in accordance with said ATR shall not be less than the present auditor's fee of an existing client.

There seems to be contradiction between the two clauses of the ATR. Our previous auditors were charging Rs. 150,000 as audit fee for the year ended June 30, 2015. If we ask our present auditor to charge minimum audit fee of Rs. 75,000 as closed operation segment, then they refer clause 7 of the ATR, which require not charging less audit fee than the previous year charge.

As our mill has discontinued its business operations. ICAP is requested to clarify, how the present auditor can charge minimum audit fee of Rs. 75,000 as required in clause 5 of the ATR against clause 7 of the ATR, by restricting not to charge audit fee less than the corresponding year audit fee.

Opinion: The Committee considered your query and is of the view that the matter does not relate to ATR-14 alone because it is not a simple case of minimum fees only while the said Auditing Technical Release (ATR) - 14 covers only the aspect of the minimum fees and doesn't prescribe the maximum fees that can be charged in that category. The inquired matter relates to the fees to be charged by an incoming auditor. From the information provided, there seems to be no major change in ground realities and volume of work from previous year to current year for which the incoming auditor has reduced the fee by 50%.

The Committee feels that the matter of fees at the occasion of change of auditors' should be viewed by the incoming auditor as to whether application and adherence to the provisions of clauses (7) relating to 'communication' and (11) relating to 'undercutting' of Part I of Schedule I of the Chartered Accountants Ordinance, 1961 was made or not.

The Committee would also like to refer section 240.1 of the Revised ICAP Code of Ethics for Chartered Accountants 2015 (the Code) which is reproduced below for your ready reference:

"Fees and Other Types of Remuneration

When entering into negotiations regarding professional services, a chartered accountant in practice may quote whatever fee deemed to be appropriate commensurate with the nature and service to be rendered. However, in such cases, chartered accountants in practice should be careful not to quote fee lower than that charged by the chartered accountants in practice previously carrying out the audit unless scope and quantum of work materially differs from the scope and quantum of work carried out by the previous auditor, as it could then be regarded as undercutting."

It is solely the responsibility of the incoming auditor to confirm that his appointment did not amount to undercutting.

In view of the above, the Committee is of the view that the incoming auditor cannot accept fees less than the predecessor auditor, in accordance with the

requirements of clause No.7 of ATR-14 and section 240.1 of the Code, on the assumption that the quantum of work is the same.

(December 20, 2016)

2.4 Signing of the audit report of EOBI

Enquiry: The particulars of query are:

- We were appointed as auditors of EOBI for the years ended June 30, 2007 to June 30, 2011.
- The audits for the years ended June 30, 2007 to June 30, 2010 were duly completed and audit reports were issued.
- We finished the field work for the audit of the year ended June 30, 2011 and provided the management of EOBI with our initialed audit report along with the financial statement for the year initialed for the purpose of identification.
- We in our cover letter requested the management of EOBI to have the financial statements approved by its Board of Trustees and meet other signing conditions after which we would sign our report.
- Due to various issues and changes in the Board of Trustees and management of EOBI neither the financial statements were approved nor the signing conditions met.
- Subsequently, the new Board of Trustees of EOBI appointed another firm of Chartered Accountants for the year ended June 30, 2012 onwards.
- The management of EOBI has now approached us to issue our audit report for the year ended June 30, 2011 as the financial statement have now been approved by the Board.

Considering the above facts, the Committee is requested to guide us whether under these circumstances we can issue the audit report on the financial statement for the year ended June 30, 2011, especially considering the fact that at present we are not the auditors of EOBI.

Opinion: Considering the fact that the Board of Trustees (the Board) of EOBI changed prior to the approval of financial statements for the year ended June 30, 2011, and subsequently, the newly formed Board appointed another firm of chartered accountants as auditors for the year ended June 30, 2012, prior to the issuance of the signed audit report for the year ended June 30, 2011 by the predecessor auditor.

This has created an anomaly as traditionally the draft audited financial statements are approved by the Board and the retiring auditor sign the audit report thereon, prior to the appointment of the new auditor.

Given the fact that EOBI Act and Rules are silent on the above issue, therefore in Committee's view, there is nothing barring the auditor to issue an audit report now (in the current date), provided that the financial statements and management representation letter are (now) approved and signed by the current Board and

subsequent events' effect on financial statements is considered by the auditor keeping in view the date of (now) the audit report.

Attention may also be drawn to the paragraphs 41 and A38 - A41 of ISA 700, 'Forming an Opinion and Reporting on Financial Statements':

41. The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that: (Ref: Para. A38 - A41)

- (a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
- (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Both paragraphs 41 and A41 of ISA 700 explain that the audit process is not complete until those with the recognized authority have asserted that they have taken responsibility for the financial statements, which is evidenced through approval of the Board. Accordingly the retiring auditor is obliged to sign the audit report for 2011, as all audit procedures have been completed unless something else has materialized during the intervening period.

Further, the auditor's responsibility under ISA 560, 'Subsequent Events,' will stretch from July 1, 2011 to the date of the auditor's report, and may require the performance of additional audit procedures.

In the light of above, the Committee is of the view that the retiring auditor may sign the audit report for the year ended June 30, 2011, after the financial statements have been approved by the Board.

However, for extra caution, the retiring auditor is also advised to act under legal advice.

(January 09, 2017)

2.5 Appointment of Auditors

Enquiry: Background Information:

- 1- Audit Firm issued quotation of audit fee against a request from Private Limited Company.
- 2- The Company appointed them as their auditors in AGM, without complying with the requirements of Section 253 of the Companies Ordinance, 1984.
- 3- On intimation of appointment from Company, the new Auditors inquired, if the Company has complied with the requirements of Section 253 of the Companies Ordinance, 1984 and wrote to retiring Auditor for professional clearance.

4- Retiring Auditor responded that due to non-compliance by the Company, they believe new appointment is invalid and question of professional clearance does not arise.

5- On receiving information from the Company, regarding non-compliance with section 253, the new auditors sought views of SECP and ICAP on the matter, who suggested that the new appointment is valid.

6- Views of SECP and ICAP were shared with retiring Auditors, whereas no response was received thereafter, despite several reminders.

Queries:

A) Would the new auditor be guilty of professional misconduct in terms of clause 7 & 8 of Part 1 of 1st Schedule to Chartered Accountants Ordinance, 1961, if he accepts the appointment, even after obtaining attached clarification from SECP and ICAP;

B) If the Institute believes that accepting this engagement would lead to a professional misconduct, would the new auditor be required to resign from the position (since Company believes, based on SECP opinion, that they have appointed the auditors) or should he simply refrain from accepting the engagement (since, the appointment has not yet been accepted by the new Auditors);

C) If the new auditor resign, and the Company fills in casual vacancy by appointment of another firm other than retiring auditors, would that other firm be guilty of professional misconduct in terms of Clause 8 of Part 1 of 1st Schedule to Chartered Accountants Ordinance, 1961;

D) If the new auditor refuses to accept the appointment, based on non-serving of notice and Commission appoints them again u/s 252(6) of the Companies Ordinance, 1984 or SECP appoints any firm other than retiring auditors, would the new auditor appointed by the Commission be guilty of professional misconduct, if they accept the engagement.

Opinion: The Committee discussed your enquiry and its views on each of the questions are as follows:

On Query A, B & C, the Committee is of the view that provisions related to professional misconduct in case of acceptance of appointment of auditor by practicing member are appropriately covered in Schedule 1 of Part 1 of the Chartered Accountants Ordinance, 1961 and under section 210 '*Professional Appointment*' of the revised ICAP Code of Ethics 2015.

On Query D, the Committee is of the view that an auditor appointed under section 252(6) is also required to communicate in writing with the outgoing auditor before accepting the appointment.

(February 06, 2017)

COMPANIES ORDINANCE, 1984

3.1 Section 208 of the Companies Ordinance 1984

Enquiry: We have encountered a technical issue at one of our client. There are two group companies of which one is public-unlisted, hereinafter referred as 'First Company', and the other is a private limited, hereinafter referred as 'Second Company'. First Company has given loan to the Second Company and is charging interest on it under compliance of Section 208 of Companies Ordinance, 1984. The Second Company has no business operations at present and it also doesn't have smooth financial cash flows which due to which it is sure that it will not be able pay back even the principal amount. Note also that the Second Company's audit report is being issued with emphasis matter paragraph due to going concern issue. Therefore, we need ICAP's assistance, whether we can reverse the interest accrued which seems to be dummy accrual in both of the companies and whether we can stop further accruals.

Furthermore, we also need to inquire that if we can classify the above mentioned loan as non-interest bearing payable at convenience of the First Company, then whether TR-32 is applicable on this financial instrument.

Opinion: We would like to refer relevant clauses of section 208 of the Companies Ordinance, 1984 (the Ordinance):

“208. Investments in Associated companies and undertaking-

- (1) Subject to sub-section (2A) a company shall not make any investment in any of its associated companies or associated undertakings except under the authority of a special resolution which shall indicate the nature period and amount of investment and terms and conditions attached thereto.

Provided that the return on investment in the form of loan shall not be less than the borrowing cost of investing company.

- (2) No change in the nature of an investment or the terms and conditions attached thereto shall be made except under the authority of a special resolution.

(2A) The Commission may-

(a) by notification in the official Gazette, specify the class of companies or undertakings to which the restriction provided in sub-section (1) shall not apply; and

(b) through regulations made thereunder, specify such conditions and restrictions on the nature, period, amount of investment and terms and conditions attached thereto, and other ancillary matters, as it deems fit.”

Under section 208 of the Ordinance, the rate of return on loan should not be less than prevailing market rate of return on similar deposits or borrowing cost of the investing company. Further, section 208 of the Ordinance and clause 8 of the “*Companies (Investment in Associated Companies or Associated Undertakings) Regulations, 2012*” (the Regulations) explain that the terms and nature of the loan, and any subsequent change thereto shall be made with the authority of a special resolution of the investing company. However, section 208 and the Regulations do not permit provision of a non-interest bearing loan to the associated company, which is ultra-virus to law.

The impairment due to un-collectible status of financial assets is based on the entity’s assessment of receivables from the counterparties, and shall be dealt in accordance with the paragraph 58 of IAS 39 ‘*Financial Instruments: Recognition and Measurement*’ (Volume 2009) and provisions of section 196 of the Ordinance.

In view of the above, the investing company shall consider the requirements of section 208 of the Ordinance to account for the interest on loan provided to the associated company.

(March 20, 2017)