The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

Topic wise Selected Opinions

IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors

Table of Contents

1. Technical Query on Common Control

Enquiry:

Common Control

	A	B	C
Percentage of Shareholding in 'Z'	3.19	11.18%	18.44%
Percentage of Shareholding of A in C			50.01 %
Percentage of Shareholding of A in B		60.25%	
Total Direct & Indirect Shareholding of A' in 'Z'	19.14%		

The question arises whether this constitutes Business Combinations under Common Control (BCUCC)?

The issues related to BCUCC are still at the discussion stage at IASB (refer to IFRS-Staff Paper of September 2013). IFRS-Staff Paper also refers to the discussion paper of European Financial Reporting Advisory Group-EFRAG.

IFRS-Staff Paper suggests that the scope of 'common control' could possibly be restricted to transactions within a group controlled by a single ultimate parent entity.

There also suggestions that control is only possible if the subsidiaries are wholly owned subsidiaries.

ACCOUNTING PRACTICES
Both the above referred discussion papers acknowledge prevalent diverse accounting treatments. These include Acquisition Method, Predecessor Accounting (Purchase Method & Pooling of Interests) and Fresh Start Accounting.

It was also suggested by many respondents to the discussion paper of EFRAG that diversity in accounting treatment was not necessarily undesirable.
In the bifurcation and subsequent merger under consideration all requirements of the Purchase Method were applied which also conforms with the acquisition method with the exception of creation of Capital Reserve.

Application Of IAS-8

IAS 8 Para 10,11 & 12 'Applying Changes in Accounting Policies' stipulates

> ***Para-10:*** *In absence of an IFRS that specifically applies to* a *transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is.*
> a) *Relevant to the economic decision making needs of the users, and*
> b) *Reliable, in that financial statements.'*
>
> *I. Represent faithfully the financial position, financial performance and cash flow of the entity,*
> *II. Reflect the economic substance of transactions, other events and conditions and not merely the legal form,*
> *III. Are neutral i.e. free from bias,*
> *IV. Are prudent, and*
> *V. Are complete in all material respects.*
>
> ***Para-11****. · In making the judgement described in paragraph 10 management shall refer to and consider the applicability of the following sources in descending order:*

a) *The requirements in IFRSs dealing with similar or related issues, and*

b) *The definition, recognition criteria measurement concepts for assets and liabilities, income and expenses in the 'Framework'.*

Para-12: *In making the judgment described in paragraph* 10 *management* ***MAY*** *also consider the most recent pronouncements of other standard-setting bodies that use* a ***SIMILAR CONCEPTUAL FRAMEWORK*** *to develop accounting standards, other accounting literature and accepted industry practice, to the extent that these do not conflict with the sources in paragraph 11.*

If you examine the Economic Substance particularly in the case of Company 'B' & 'C', assets and liabilities were transferred to them in lieu of investments already in 'Z'. As such the excess of net assets transferred to 'B' & 'C', has to be recognized as gain on disposal of investments.

Some practicing firms advocate the application of US GAAP in accordance with Para 12 of IAS-8. My objection to the same is that till US GAAP is totally converged there are a lot of differences between US GAAP & IFRSs. US GAAP doesn't even recognize the Revaluation Model, the very essence of Business Combinations.

As such there is no justification to equate US GAAP as Similar Conceptual Framework and the same should not be applied.

We shall we grateful to provide technical opinion on the above referred matters. We also seek the opinion of the Technical Committee on application of US GAAP.

Opinion:

The Committee considered both of your enquiries and concurs with your views that that in the absence of IFRS that specifically applies to any transaction, it is necessary for an accounting policy to be developed in accordance with the guidance given in para 8 to 10 of IAS 8.

For transactions which have economic substance, because IFRS does not specify the accounting approach to be followed, an entity should select one of the following two approaches as an accounting policy choice to be applied consistently to all business combinations involving entities under common control:

- The acquisition method (as set out in IFRS 3), or
- Book value accounting (often referred to as the ‘pooling of interests’ method).

The acquisition method is only available if a business combination involving entities under common control has economic substance. If a transaction does not have economic substance, then acquisition accounting is not appropriate and book value accounting is followed instead. Careful consideration needs to be given to whether a common control transaction has economic substance, from the perspectives of all entities involved. This is because it is possible for a business combination under common control to be undertaken at the direction of a parent entity, and not because there is a substantive transaction with an unrelated third party. Factors to consider include:

- The purpose of the transaction
- Whether the transaction price is at fair value (when the transaction is not effected through the issue of equity shares)
- The activities of the entities involved in the transaction.

For substantive transactions, the rationale for applying IFRS 3 would be that, although it is part of a group of entities under common control, the acquirer is still a separate entity in its own right. The rationale for book value accounting would be that the business has simply been moved from one part of a group of entities under common control to another. Because business combinations involving entities under common control typically arise from businesses being moved around a group as part of a restructuring, to effect a tax planning arrangement, or in preparation for the sale or listing of part of an existing group, it is likely that the appropriate approach will be to use book value accounting.

Based on information provided to us, the Committee is of the view that there is no economic substance in this transaction. Further, in either case the gain arising on such business combination would go to equity and will not be recognized in P&L.

With regard to your query regarding application of US GAAP, the Committee believes that it is matter of judgment of the management of the Company to decide which similar conceptual framework or other accepted industry practices to be used which is best appropriate with the scenario, to the extent that it is not in conflict with paragraph 11 of IAS 8.

(June 27, 2014)

2. Accounting Treatment resulting from amendment in Prudential Regulation R–8, Classification and Provisioning of Assets

Enquiry:

We seek the committee's opinion on whether to account the effects of the amendment introduced in R- 8 of not considering the benefit of Forced Sale Value (FSV) as a change in Accounting Policy or a Change in Estimate after consideration of the following.

A. Definitions and Elaboration of certain relevant terms.

1. The term ***Accounting Policy*** has been defined in Para 5 of IAS 8 as *accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements*.

2. Elaborating on the definition, an entity ***adopts*** Accounting Policies;

   - that are most appropriate to its particular circumstances for the purpose of giving a true and fair view,

   - they are reviewed regularly to ensure that they remain appropriate, and are changed when a new policy becomes more appropriate to the entity's particular circumstances; and

   - that sufficient information is disclosed in the financial statements to enable users to understand the accounting policies adopted and how they have been ***applied.***

3. Similarly, an entity ***applies*** accounting policies to ***reflect the effects of transactions*** and other events through recognizing***, selecting measurement bases for, and presenting assets, liabilities, gains, and losses and changes to shareholders' funds***.

4. ***Estimation Techniques.*** Accounting policies do not include estimation techniques which are the ***methods and estimates adopted by an entity to arrive at monetary values, corresponding to the measurement basis*** selected, for assets, liabilities, gains, losses and changes to shareholders' funds. The estimation techniques for example include methods of depreciation, such as straight – line and reducing balance, applied in the context of a particular measurement basis, used to estimate the proportion of the economic benefits of a tangible fixed asset consumed in a period.

5. ***Measurement*** is defined in para 99 of the Framework, as the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement.

6. ***Measurement basis*** are those ***monetary attributes*** of the elements of financial statements (assets, liabilities, gains, losses, and changes to shareholders' funds) that are reflected in financial statements. Measurement basis are defined in para 100 of the Framework as ***A number of different measurement basis are employed to different degrees and in varying combinations in financial statements. They include the (a) Historical Cost (b) Current Cost (c) Realisable (settlement) Value and (d) Present Value.***

7. ***Monetary Attributes*** The different attributes or values of an element of a financial statement are monetary attributes. In other words, the different measurement basis defined in para 100 of the framework are monetary attributes.

8. ***Change in accounting estimate*** is defined in para 5, Definition of IAS 8 as, Change in Accounting Estimate is an adjustment of the carrying amount of an asset or a liability, or

the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, asset and liabilities. Changes in accounting estimates results from new information or new developments and accordingly are not corrections of errors.

B. Discussion

1. The determination, of whether a change is to be recognized as a change in accounting policy or estimate, will require carrying out an analysis of the effect of the change. This can be done by testing the effect on three general principles arising from the definition of accounting policy relating to preparation and presentation of financial statement being, the recognition (recognition criteria), presentation and the measurement basis. A change in any one of the general principles will have to be accounted for as a change in accounting policy.

2. The general understanding of the three principles is briefly summarized for clarity as follows;

   - Recognition Criteria. How to recognize elements of financial statements (assets, liabilities, gains or losses) as a result of the transaction,

   - Presentation. Where to present the elements in the financial statement i.e. balance sheet or profit and loss account.

   - Measurement basis. How to attribute a monetary amount to the elements that are recognized?

3. R – 8 provides guidelines to Banks and DFIs in the matter of classification of their asset portfolio and provisioning there against.

4. Through SBP circular the application of IAS 39 has been deferred in the case of Banks and DFIs and therefore the classification of financial assets as well as the ***provisioning*** is be according to SBP circulars and Regulations. In view of the principle that where compliance with a particular accounting standard is inconsistent with the requirements of legislature, entities are permitted to depart from the requirements of that standard and therefore the principles outlined in the circulars are effected to comply with the guidelines and therefore R- 8 is adopted for presentation of financial assets by Banks / DFIs. It is clarified that the word provisioning appearing in R – 8 is in the nature of impairment and not in the nature of ordinary provisions. (Reference para 7 of IAS 37).

5. Before amendment, R – 8 required Banks / DFI's to classify and determine, the category of classification using the time based criteria. The time based criteria requires a provision percentage (10 %, 25 %, 50 %, 100%) of the difference resulting from the outstanding balance of principle less the amount of liquid assets realizable without recourse to a court of law and adjusted forced sale value of mortgaged /pledged assets as valued by valuers fulfilling prescribed eligibility criteria. In other words, by taking the benefit of FSV the future potential cash flows from securities is considered.

6. The carrying amounts of loans / advances after giving effect to the provisioning criteria prescribed in R – 8, somewhat resembles the concept of ***present value***, defined for Assets in para 100 (d) as, ***Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.***

7. After amendment in R – 8 the benefit of FSV is now not available while making provisions, resulting in a monetary attribute of the assets that will not meet the test of Present Value Definition. Instead the subject assets will now reflect a hybrid monetary basis resembling a combination value of Current cost and Realisable (Settlement) value

thus due to this change in the ***measurement basis criteria the same will result in a change of accounting policy in accordance with paragraph 35 of IAS 8.***

8. The amendment has also effectively taken the option (refer para 4 of R -8) available with the Banks / DFIs of availing the benefit of collateral held against loans / advances by considering the value determined by the valuers thus leaving only one measurement basis i.e. the hybrid basis and therefore the amendment will need to be accounted for as a change in accounting policy.

9. Argumentatively the change would have been considered as a change in estimate if the subject amendment provided a different basis of valuation for collateral / securities or alternately required estimation of impairment / provisioning by using a cash flow model in which case ***the measurement basis remaining the same a change in the estimation technique would have occurred thus giving rise to recognition of the effects of amendment as a change in estimate.***

10. This finds further strength from the fact that the objectives against which an entity judges the appropriateness of accounting policies to its particular circumstances are;

- Relevance;
- Reliability;
- Comparability; and
- Understandability

being the headings defining the qualitative characteristics of financial statements as set out in IAS 1, Presentation of Financial Statements.

11. The Change in Accounting Policy argument also finds strength from reading of paras 7 & 14

    (a) of IAS 8. Para 14 (a) requires that ***an entity shall change an accounting policy only if the change:***

    (a) is required by a Standard or interpretation; or

    (b) …..

12. This is due to the fact that the amendment in R – 8 has the effect of a change due to amendment in R – 8 which results in changing the measurement basis as it meets the test in the definition of ***Measurement defined in para 99 of the Framework*** for the reason that the amendment results in a change in the ***monetary amount of the asset at which it is carried in the balance sheet*** which is different in principle from the previous basis***.***

13. Therefore where an entity, based on the above considerations, adopts the R -8 criteria of provisioning as a change in accounting policy it should account for the current amendment in R – 8 on the same principle which will enable it to meet the objectives of financial statement comparability to provide a better understanding of the current period financial statements.

Opinion:

Your attention is drawn to the following paragraph of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors':

> **5. The following terms are used in this Standard with the meanings specified:**
>
> ***Accounting policies* are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.**
>
> **A *change in accounting estimate* is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.**

As the revised circular of SBP is not allowing banks to take any benefit of FSV against non-performing loans for calculating provision therefore the Committee is of the view that it is an adjustment of the carrying amount of liabilities for valuation of the non- performing loan for the purpose of provisioning. The Committee therefore is of the opinion that this change should be considered as change in accounting estimate rather than change in accounting policy.

However, if an entity treated the change in R – 8 as change in accounting policy instead of change in accounting estimate in the financial statements of previous year, the Committee is of the view that this should be considered as an error and should be dealt with as per paragraphs 41 to 49 of IAS 8.

(March 8, 2008)

3. Change in Basis for charging depreciation

Enquiry:

The new IAS-16 has introduced certain changes in accounting for depreciation on property, plant and equipment effective from accounting periods commencing on or after 01 January 2005. These changes, inter-alia, require that an entity should start charging depreciation from the time the asset is available for use till the time it is no longer available. In the past, most of the companies charged full depreciation in the year the asset was acquired, whereas no depreciation was charged in the year it was deleted.

There is certain confusion in accounting circles whether this change is a change in accounting policy or change in estimate.

Opinion:

The Committee would like to draw your attention to the following paragraphs of IAS 8 and 16:

Definition Paragraph 5 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors: -*

A Change in Accounting Estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

34. An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.

IAS 16 '*Property, Plant and Equipment* ':

51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and if expectations differ from previous estimates, the change shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

In view of the above paragraphs the Committee is of the opinion that if an entity changes its practice of charging full year depreciation in the year of addition and no depreciation in the year of disposal to monthly or quarterly basis then such change would be considered as change in accounting estimates and should be treated as per paragraphs 36 to 40 of IAS 8.

(April 1, 2006)

4. IAS – 8, Accounting Policies, Changes in Accounting Estimates and Errors

Enquiry:

Paragraph 30 of revised IAS 8-Accounting Policies, Changes in Accounting Estimates and Errors states as follows: -

> "when an entity has not applied a new Standard or Interpretation that has been issued but is not yet effective, the entity shall disclose: -
>
> (a) this fact; and
>
> (b) known or reasonably estimable information relevant to assessing the possible impact that application of the new Standard or Interpretation will have on the entity's financial statements in the period of initial application".

In view of the above requirement, a question arises whether the IFRSs and IFRIC's Interpretations which have been issued by the IASB and IFRIC but have not been notified by Securities and Exchange Commission of Pakistan and IAS 39 and 40, the applicability of which to banks and DFIs in Pakistan is currently deferred by the State Bank of Pakistan, fall under the above paragraph or not ? If yes, then, are companies, banks and DFIs expected to give disclosures in the financial statements for the year ended December 31, 2005 as required under the above paragraph even if the applicability of an IAS/IFRS or IFRIC Interpretation may have been deferred in Pakistan for the time being?

We look forward to receiving the Institute's guidance in this regard at the earliest.

Opinion:

The appropriate Committee of the Institute considered paragraph 30 of IAS 8 reproduced in your above-mentioned enquiry and is of the opinion that those IAS/IFRS which have been made effective by IASB but yet to be notified by SECP or notified but deferred either by SECP or SBP (such as IAS 39 and 40 in case of banks and DFIs) for any reason, the disclosure required by paragraph 30 of IAS 8 is not mandatory.

It may be noted that SIC or IFRIC are not separately adopted as the Committee is of the view that they are considered to be adopted automatically when relevant IAS/IFRS are notified.

(February 4, 2006)

5. Clarification regarding Deferred Costs and restricted use of Cash and Cash Equivalents

Enquiry:

You are requested to kindly give your opinion on the following two issues.

1) Deferred Costs – As you are aware that the Fourth Schedule to the Companies Ordinance, 1984 has been substituted by the Securities and Exchange Commission of Pakistan (SECP) vide its Notification No. SRO 589 (I)/2004 dated July 05, 2004. Through this revision the provision relating to the deferment and amortisation of costs covered by Para 5(B) of Part II of the substituted Fourth Schedule has been deleted.

According to the deleted Para 5(B), the listed companies were required to defer and amortise the preliminary expenses, **discount allowed on the issue of shares, if any, and expenses incurred on the issue of shares including any sums paid by way of commission or brokerage on the issue of shares.** Now after the deletion of this requirement the question arises what would be the accounting treatment for recognition of these kinds of costs. As the revised Fourth Schedule is silent on this issue, therefore, we would have to refer to the requirements of the International Accounting Standards.

The aforesaid costs may be divided into following three parts.

a) Preliminary expenses;

b) Discount allowed on issue of shares; and

c) Expenses incurred on the issue of shares.

The appropriate Committee of ICAP has already deliberated the issue of accounting treatment for the above kinds of costs and has issued two opinions on the subject reported as Opinion No. 1.1 (Volume VII) and Opinion No. 1.3 (Volume VIII) in the Selected Opinions of ICAP. The accounting treatment suggested by ICAP in these opinions is given hereunder in seriatim:

i) All preliminary expenses should be charged off in the same period in which these are incurred (first paragraph, opinion 1.3 – Volume VIII);

ii) Since we have a concept of par value in place therefore the best possible treatment could be to show the amount of discount on issue of shares as a deduction from equity and disclose it (second-last paragraph, opinion 1.1 – Volume VII);

iii) The transaction costs of an equity transaction should be accounted for as a deduction from equity, net of any related income tax benefit (no specific opinion but discussed in sixth paragraph from last, opinion 1.1 – Volume VII).

The above reported opinions clearly demonstrate the understanding of ICAP for treating these kinds of costs, which is in line with the requirements of the International Accounting Standards.

However, I could not appreciate the rationale behind the recommendations given by ICAP (as stated on ICAP website) to the SECP, in response to which the latter has issued the Circular No. 1 of 2005 dated January 19, 2005. It is further stated on the ICAP website that through this circular SECP has given the so-called relaxation to the listed companies on deferred costs. The relevant portion of the said circular is given hereunder for reference.

"**With a view to remove practical difficulties** being faced by listed companies and their subsidiaries as a result of revision of Fourth Schedule to the Companies Ordinance, 1984 w.e.f. July 5, 2004, the Securities and Exchange Commission of Pakistan is pleased to clarify that:

i) The listed companies and their subsidiaries which were carrying deferred costs in their financial statements as on July 5, 2004, **are allowed to continue to treat such costs according to the requirements of the substituted Fourth Schedule**. However, after July 5, 2004 such companies are not allowed to include any further deferred cost in their financial statements……"

If the continuance of treatment of deferred costs in accordance with the requirements of the Fourth Schedule is a relaxation for the listed companies (as claimed by both ICAP and SECP), then to my mind the substance of the above circular is that in future discount allowed on issue of shares and expenses incurred on issue of shares are to be charged off to profit and loss account in the period in which these expenses are incurred. If such is the case, then such a treatment will be clearly in conflict with the requirements of the International Accounting Standards. It also appears that ICAP while recommending the above treatment for deferred costs has changed its stance as given in the above-referred opinions.

According to my understanding the treatment of deferred costs as envisaged in the above circular would adversely affect both the company and its shareholders, as charging off the full amount of discount on issue of shares or share issue expenses in period of incurrence would distort the results of the company as well as deprive the shareholders from dividend.

If ICAP or SECP truly wants to give some relaxation to listed companies then the listed companies should be allowed to deduct from the equity all the existing (i.e. discount on issue of shares and share issue expenses incurred and deferred before July 5, 2004) as well as future costs on account of discount on issue of shares and share issue expenses in accordance with the requirements of the International Accounting Standards.

Keeping in view the above discussion you are requested to kindly clarify the following:

i) Whether the discount on issue of share capital and share issue expenses incurred before July 5, 2004 and carried as on that date as deferred cost in the financial statements, may be deducted from the equity by adjusting the opening retained earnings in accordance with the requirements of IAS 8;

ii) Whether the costs incurred on account of discount on issue of share capital and share issue expenses incurred after July 4, 2004 may be charged directly to equity by deducting from the retained earnings. If no, how should these costs be treated in the financial statements; and

iii) Whether the transaction costs of equity as explained in paragraph 37 of IAS 32 (revised) include underwriters' commission.

2) **Restricted use of cash and cash equivalent** – Please refer to the Para 57 of IAS 1 (revised 1997) which states:

"57. An asset shall be classified as current when it satisfies any of the following criteria:

…… (d) **it is cash or cash equivalent (as defined in IAS 7** *Cash Flow Statements*) **unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.**

Keeping in view the above stated provision of IAS 1, you are requested to kindly clarify whether share subscription money received by a company from the Rights Issue (made by the Company to generate funds for expansion project) and held in the current / savings accounts of the Company as at balance sheet date is 'cash and cash equivalent restricted in use' for the purposes of Para 57(d) of IAS 1 and should be presented as non-current asset.

Opinion:

1 Deferred Cost

i) Whether the discount on issue of share capital and share issue expenses incurred before July 5, 2004 and carried as on that date as deferred cost in the financial statements, may be deducted from the equity by adjusting the opening retained earnings in accordance with the requirements of IAS 8;

Yes. if the entity wishes to change its accounting policy relating to capitalisation of deferred expenses, it will have to comply with relevant requirements of IAS 8.

However, if the entity decides to continue with its current accounting policy, then the deferred costs should be accounted for in the financial statements of the entity according to the provisions of revised Fourth Schedule to the Companies Ordinance, 1984 and those of Circular 1 of 2005 dated January 19, 2005 issued by the SECP.

ii) Whether the costs incurred on account of discount on issue of share capital and share issue expenses incurred after July 4, 2004 may be charged directly to equity by deducting from the retained earnings. If no, how should these costs be treated in the financial statements; and

Yes. All costs incurred on account of discount on issue of share capital and share issue expenses incurred after July 4, 2004 are required to be charged directly to equity by deducting from the reserves.

As far as Selected Opinions of the Institute referred to in the query are concerned, they were issued prior to the issuance of revised Fourth Schedule and SECP Circular 1 of 2005. Opinion No. 1.1 (Volume VII) and Opinion No. 1.3 (Volume VIII) of the Selected Opinions were issued by the Institute in the year 2001-2002 and 2002-2003 respectively; while revised Fourth Schedule and SECP Circular 1 of 2005 were issued on July 5, 2004 and January 19, 2005 respectively. We would like to draw your attention towards the introduction of Selected Opinions which explicitly enunciates that:

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

iii) Whether the transaction costs of equity as explained in Para 37 of IAS 32 (revised) include underwriters' commission.

Prima facie perusal of Para 37 of IAS 32 (revised) reveals that the transaction costs of an equity transaction include underwriters' commission.

2. Cash and Cash Equivalent

Whether share subscription money received by a company from the Right Issue (made by the Company to generate funds for expansion project) and held in the current / savings accounts of the Company as at balance sheet date is 'cash and cash equivalent restricted in use' for the purposes of Para 57(d) of IAS 1 and should be presented as non-current asset.

From review of revised Fourth Schedule to the Companies Ordinance, 1984, it appears that no specific classification has been prescribed for cash and cash equivalents which are restricted from being used; hence the cash and cash equivalents which are restricted from being used would be classified according to the provisions of paragraph 57 of IAS 1. As far as treatment of cash proceeds of right issue is concerned, the Companies Ordinance, 1984 and Companies (Issue of Capital) Rules, 1996 do not appear to have imposed any restriction on the utilization of cash proceeds of right issue. Hence, provisions of paragraph 57 of IAS 1 would not apply on the cash proceeds of right issue and accordingly the same may be classified as current asset.

(December 10, 2005)

6. Disclosure and Audit Report on untaxed funds declared and credited in Profit & Loss Account

Inquiry:

Under the Tax Amnesty Schemes from time to time or foreign remittance exemption provided under section 111(4) of the Income Tax Ordinance, 2001, individuals and companies declare the untaxed funds and credit the same in profit and loss account. Examples are FEBCs. US $ Bonds, Tax Amnesty 2000, foreign remittance through proper banking channels etc. taken into account.

We will appreciate if you provide technical guidance as to disclosure of such events in the accounts of the clients and audit reports thereon. The following points need guidance:

1. Where these amounts should be shown I) in Profit and Loss Account as other income ii) in Profit and Loss Appropriation Account or iii) taken to Balance Sheet as Capital Reserve.

2. **Accounts** – disclosure – whether the following disclosure is in order if not what should be the proposed disclosure.

Quote

Note _____ Foreign Remittance

The company has brought foreign remittance of US $ ____ equivalent to Rs. _____ for investment.

Unquote

3. **Audit Report** – highlight

In the third para, last line, after the words "after due verification", "'and without commenting on Note ____' we report _____"

Whether the above highlight / reference is enough if not what should be the proposed reporting.

We will appreciate an early reply in this respect.

Opinion:

With reference to the queries raised by you, the appropriate Committee of the Institute would like to draw your attention towards the following paragraphs of IAS-8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* which provide complete guidance in this respect: -

Fundamental Errors

31. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights. The correction of these errors is normally included in the determination of net profit or loss for the current period.

Benchmark Treatment

34. The amount of the correction of a fundamental error that relates to prior periods should be reported by adjusting the opening balance

of retained earnings. Comparative information should be restated, unless it is impracticable to do so.

Allowed Alternative Treatment

38. The amount of the correction of a fundamental error should be included in the determination of net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro-forma information, prepared in accordance with paragraph 34, should be presented unless it is impracticable to do so.

With regard to point No. 3 of your above enquiry, your attention is drawn to the following paragraph of ISA-700, *The Auditor's Report on Financial Statements: -*

Matters That Do Affect the Auditor's Opinion

36. An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

(a) there is a limitation on the scope of the auditor's work; or
(b) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion. These circumstances are discussed more fully in paragraphs 41–46.

As such for further guidance you are advised to refer to paragraphs 37-46 of ISA –700.

(May 8, 2004)

7. Professional Opinion on Markup previously capitalized

Inquiry:

We are in the process of finalization of audit of a client (public company) for the year ended September 30, 2003. In this respect we seek your opinion on certain issues given below:

Facts of the Case

In the year ended September 30, 1999, on reaching a restructuring agreement with lender bank, whereby outstanding mark up on loan, which was not recognized by the company, was converted into demand finance. The company capitalized current and prior year's mark up on long term loans from the lender bank aggregating to Rs. 140 million towards the cost of plant and machinery. In accordance with generally accepted accounting principles, this should have been charged to profit and loss account as it represented accrued mark-up on long-term loan, which was not recognized previously by the enterprise. We, as the auditors of the company qualified the capitalization of mark-up in all financial statements issued subsequent to the restructuring transaction of 1999, pointing out that the capitalization of accrued markup was not in line with generally accepted accounting principles. Board of directors' report, gave an explanation for qualification that "the mark up of Rs.140 million was due against the loan which was obtained for the acquisition of plant and machinery. Keeping in view the capacity and useful life of the assets vis-à-vis financial restructuring package approved by the bank, the management of the company decided to capitalize the mark up".

ISSUE I

During the year ended September 30, 2003, the company again entered into a new settlement agreement with the same lender bank on August 25, 2003 under BPD circular No. 29 dated October 15, 2002. The loan was restructured on the basis of forced sales value determined by valuer of the lender bank whereby the company would have to make payments of Rs.155 million as full and final settlement of total outstanding of Rs.327 million. The new liability would be retired through a down payment of Rs.15 million and twelve equal halves yearly installment due from November 23, 2003.

The above settlement agreement resulted into recognition of waiver of loan liability of Rupees 171.9 million by the company in the accounting year 2003.

The company has now also decided to reverse its earlier treatment of capitalization of markup amounting to Rs.140 million.

Option I

The capitalized mark up in the year 1999 is to be charged to profit and loss account after netting off the waiver of long-term loan received during the year 2003. Following is the manner in which the effect can be disclosed:

PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED SEPTEMBER 30, 2003

		2003 Rs. in million	2002 Rs. in million
Profit/(loss) for the year before tax		(55.0)	(5.0)
Taxation		(2.0)	(3.5)
Profit after Taxation		(57.0)	(8.5)
Extra Ordinary Items	(Note 1)	57.7	
Profit after Tax and Extra Ordinary Items		0.7	(8.5)

EXTRACTS FROM NOTES TO THE ACCOUNTS

Note 1:
Extra Ordinary Items
(Netting Off of Waiver of Loan with Previously Capitalized Mark-up)

Waiver of Loan	171.8	-
Correction of Previously Capitalized Mark-up	(114.1)	-
Extra-Ordinary Item-	57.7	-

Option II

The capitalized mark up on long-term loan pertained to earlier years and to be adjusted against opening balance of retained earnings. Waiver of long term loan to be treated as separate line item being extraordinary item. Following is the manner in which the effect will be disclosed:

PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED SEPTEMBER 30, 2003

	2003 Rs. In million	**2002 Rs. In million (Restated)**
Profit for the year before tax	(55.0)	1.0
Taxation	(2.0)	(3.5)
Extra-Ordinary Item	171.8	-
Profit after Tax and Extra-Ordinary Item	114.8	(2.5)
Accumulated Profit/Losses Brought Forward Note 2	(276.8)	(283.7)
Accumulated Losses Carried Forward	(162.1)	(286.2)

	2003 Rs. in million	**2002 Rs. in million**
NOTE 2:		
ACCUMULATED LOSSES		
Opening accumulated losses as previously stated	(162.7)	(163.6)
Previously capitalized mark up now charged to income	(114.1)	(120.1)
Opening accumulated losses as restated	(276.8)	(283.7)
Net Profit / (Loss)	114.8	(2.5)
Closing accumulated losses	(162.0)	(286.2)

Comments

It should be noted that under option I the EPS is more realistic as compared to option II in which the EPS is inflated artificially, thus misleading the end user.

ISSUE II

Facts of the case

The settlement agreement under BPD circular 29, carries an important fact that the agreement was based on the valuation by lender bank's valuer who valued the assets on market value and afterward calculated forced sale value to determine the amount to be recovered from borrower-client.

Issue involved

This valuation is significantly less than the carrying amount of the fixed assets. However, management is of the opinion that the valuation has been carried out only for the purpose of restructuring therefore could not be used as a basis for recognition of impairment of assets. Its projections for the next five years show that value in use/depreciation based on original cost of the asset is fully recoverable. In such case do we have to provide for any impairment loss on the basis of forced sale value as determined under BPD circular 29.

We would like to have ICAP views on the above issues. Please note that we are in the process of finalization of accounts and would appreciate an early reply.

Opinion:

The appropriate Committee of the Institute has considered your above-mentioned queries and before expressing its opinion would like to draw your attention to the following paragraph of IAS 8, which states that:

FUNDAMENTAL ERRORS

31. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights. The correction of these errors is normally included in the determination of net profit or loss for the current period.

According to IAS 8 there are two ways of treating the fundamental error and they are as follows:

(A) Benchmark

34 The amount of the correction of fundamental error that relates to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated, unless it is impracticable to do so.

(B) Allowed Alternative Treatment

38 The amount of the correction of a fundamental error should be included in the determination of net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma information, prepared in accordance with paragraph 34, should be presented unless it is impracticable to do so.

After considering the above, the Committee is of the opinion that: -

Issue I:

Treatment mentioned in option II appears to be appropriate being in accordance with the benchmark treatment as prescribed in IAS 8 on “Net Profit and Loss for the Period, Fundamental Errors and Changes in Accounting Policies”.

However, the Committee feels that the following observations need to be taken care of:

- The amount of waiver of loan should not be treated as an extraordinary item, rather it is a de-recognition of a financial liability that should be treated as per paragraph 63 of IAS 39 which requires that:

> "The difference between the carrying amount of a liability (or part of a liability) extinguished or transferred to another party, including related unamortised costs, and the amount paid for it should be included in net profit or loss for the period" (IAS 39.63)

Therefore, considering the size, nature, and incidence of the item (IAS 8.16) this should be shown as a separate line item on the face of profit and loss account as "income from de-recognition of financial liability"

- In the balance sheet notes, the difference of amount of loan capitalised and carrying value thereof should be disclosed. The reversal of accumulated depreciation should also be highlighted for better presentation.

- In line number 2 of Note 2 of accumulated losses of Options II the word 'income' should be replaced with 'retained earnings'

Issue II:

The Committee would like to draw your attention towards IAS 16 "Property, Plant and Equipment" which defines impairment loss as:

> "An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount." **(IAS 16.6)**

While "***recoverable amount*** is the higher of an asset's net selling price and its value in use." **(IAS 36.5)**

In order to clearly understand the meaning of recoverable amount, we would like to quote definitions of the terms "net selling price" and "value in use" as defined in IAS 36 – Impairment:

> ***"Net selling price*** is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal." **(IAS 36.5)**
>
> ***"Value in use*** is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life." **(IAS 36.5)**

From the above it is clear that the term forced sale value in not defined/referred to in the IAS 36. Therefore, the Committee is of the view that if an impairment loss does exist, it should be measured and recognized as per the guidance available in the relevant IAS.

Moreover, the Committee would also the like to emphasize that BPD Circular 29 of State Bank of Pakistan will not be applicable to the company to which you are referring to, as the Committee assumes that the said company is not a bank while the concept of Forced Sale Value as mentioned in the said Circular is only applicable to banks particularly when a bank is determining the amount to be recovered from the borrower in case of default by the borrower.

(April 3, 2004)

8. Matter pertaining to entries in the Books of Account

Inquiry:

The facts about the matter are briefly narrated as under: -

1. The assesse, an A.O.P, carrying on steel manufacturing business filed its return for the assessment year 2000-01 (year ending 30-6-2000). The trading/manufacturing account enclosed with the return is reproduced hereunder: -

Opening stock	1,315,000	Sales	153,447,103
Purchases	134,356,834	Closing stock	61,300,000
Electricity	60,046,617		
Wages	2,695,000		
Stores	6,500,000		
Gross profit	9,833,652		
	214,747,103		**214,747,103**
	==========		==========

2. The assesse also filed a Declaration under the Tax Amnesty Scheme 2000 (TAS). In Part-I of the declaration, undisclosed income was shown at Rs. 35,000,000 which was balanced against stock-in-trade (up to 30-6-99) of an equal amount i.e. Rs. 35,000,000 shown in Part-II of the same declaration.

3. Wealth statements of the owners for the year ending 30-6-2000 reflect credit taken on account of undisclosed income declared as per Tax Amnesty Scheme 2000 (TAS).

4. Since stock-in-trade worth Rs. 35,000,000 was not visible in the trading account for the year ending 30-6-2000, a show cause notice was issued to the assesse.

5. The assesse filed a revised trading account without disturbing the gross profit declared in the original trading account. The revised trading account is reproduced below:

	Rupees
Sales – Net (Excluding Sales Tax including income declared Under TAS)	188,447,103

Cost of Sale

Opening Stock	36,315,000
Purchases excluding sales tax	134,356,834
Electricity excluding sales tax	60,046,617
Wages	2,695,000
Consumption of store items	6,500,000
	239,913,451
Less: Closing stock including declared under TAS	(61,300,000)
	178,613,451
Gross Profit	9,833,652

From the above narration of facts, the queries which come to my mind are: -

(a) What entries (debit & credit) are required to be made in the books of account for the year ending 30-6-2000 with reference to undisclosed income and stock-in-trade declared under Tax Amnesty Scheme (TAS).

(b) Whether stock declared under Tax Amnesty Scheme (TAS) is to be debited to the trading account before it is shown as part of closing stock or sales for the same year.

You are humbly requested to kindly spare your precious time to look into the matter and send reply at an early date.

Opinion:

First of all, your attention is drawn towards paragraph 31 of IAS – 8 which says: -

FUNDAMENTAL ERRORS

31. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights. The correction of these errors is normally included in the determination of net profit or loss for the current period.

In the light of above the amount of undisclosed income referred to in your letter falls under the category of fundamental errors. Now the question arises what is the treatment of fundamental errors.

According to IAS 8 there are two ways of treating the fundamental error and they are as follows:

(A) Benchmark

34 The amount of the correction of fundamental error that relates to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated, unless it is impracticable to do so.

In the case of benchmark treatment, the accounting entry would be:

Opening stock	Debit	
Retained earnings (opening)		Credit

(B) Allowed Alternative Treatment

38 The amount of the fundamental error should be included in the determination of net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma information, prepared in accordance with paragraph 34, should be presented unless it is impracticable to do so.

In this case the suggested accounting entry would be: -

Opening stock	Debit	
Current year Profit and Loss		Credit

Further your enquiry (b) is also taken care of in the above discussion.

(January 3, 2004)