The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

Selected Opinions

Volume XXIII

From July 1, 2017 to June 30, 2018

Technical Services Department

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Introduction

This is the twenty third compilation of opinions issued by the Institute's Accounting Standards Board (the Board) and the Auditing Standards & Ethics Committee (the Committee) on the enquiries raised by members, entities and regulators during the period from **July 2017 to June 2018.** This compilation of opinions is termed as "Selected Opinions".

These selected opinions are issued for the general guidance of the members of the Institute. In this document, the accounting opinions represent the opinions of the Board and opinions related to auditing and ethical matters represent the opinions of the Committee. These are not the official opinions of the Council of the Institute. The opinions are operational in 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 are based on the accounting and auditing principles on the date the Board and the Committee finalises the particular opinion. The date of finalisation of each opinion is indicated along with the opinion. Since an opinion is arrived at on the basis of the facts and circumstances of each individual query provided by the enquirer, it may change if the facts and the circumstances change. An opinion may also change due to subsequent developments in law, pronouncements made by the Institute and other relevant changes. The Institute, the Board and the Committee 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 applicable on the issue at that point in time.

Directorate of Technical Services

ACCOUNTING

1.1 Assets on Ijarah

Enquiry:

Please guide whether the finance lease liability of our client, which is a medium sized entity, be classified as operating lease as per Islamic Financial Accounting Standard 2 (IFAS 2), *Ijarah*, or finance liability as per *International Financial Reporting Standards for Small & Medium Sized Entities (IFRS for SMEs)*?

IFAS 2 was made applicable on companies through SRO 431(1)/2007. However, later SECP made changes in the Companies Ordinance, 1984 by classifying companies as small, medium and large companies and vide their SRO 929(1)/2015, SECP has specified applicability of IFRS for SMEs for medium sized entities for financial periods beginning or after January 01, 2015 and thus restricting to apply these standards while preparing financial statements of medium sized entities. These standards do not require medium sized entities to record Ijarah Assets as operating lease instead it requires applying the concept of substance over form and record asset as finance lease if it qualifies the said criteria.

Our client is a medium sized entity as per fifth schedule of the Companies Ordinance, 1984. In accordance with the SRO No. 929(1)/2015, SECP has directed the non-listed small and medium sized entities, classified under fifth schedule to the Companies Ordinance 1984, to follow applicable financial and accounting reporting standards. The applicable financial and accounting reporting standards for non-listed small and medium sized entity include IFRS for SMEs.

Opinion:

The Board considered your query and would like to draw your attention to SRO 929 of 2015 issued under the repealed Companies Ordinance, 1984 which provides classification of the companies and the accounting framework to be followed by such companies.

Further, under the repealed Companies Ordinance, 1984, SECP has notified the Islamic Financial Accounting Standard (IFAS) 2, *Ijarah,* through S.R.O 431(I)/2007 which states that:

> *"In exercise of the power conferred by sub-section (3) of section 234 of the Companies Ordinance, 1984 (XLVII of 1984), the Securities and Exchange Commission of Pakistan is pleased to direct that the Islamic Financial Accounting Standard 2, annexed to this notification, issued by the Institute of Chartered Accountants of Pakistan, shall be followed in regard to the financial statements by companies and modarabas while accounting for Ijarah (Lease) transactions."*

With regard to the enquired scenario, an Ijarah contract shall be accounted for in accordance with the IFAS 2, and the statement of compliance shall include IFAS as part of the approved accounting standards.

(October 02, 2017)

1.2 Deferred tax

Enquiry:

Our client was a manufacturer cum exporter and filing 115 (4) since its incorporation i.e. 2006. Since 2016 and 2017 its exports became around 60:40 but from next year they are again expecting their exports to be more than 80%. Should we calculate and provide for deferred tax provisions in the accounts for tax year 2017?

If yes, the company, since incorporation, is not maintaining fixed assets tax base and therefore it is difficult to calculate deferred tax for 2017. Should they take accounting base of their fixed assets as their tax base?

Opinion:

IAS 12, *Income Taxes*, prescribes the accounting treatment of incomes taxes. In relation to the deferred taxation, IAS 12 requires an entity to consider whether it is probable that recovery or settlement of the carrying amount of the asset or liability will result in future tax payments larger (or smaller) than they would be if such recovery or settlement had no tax consequences. If it is probable that such a larger or smaller tax payment will arise, IAS 12 requires an entity to recognise deferred tax liability or deferred tax asset.

The definition of deferred tax contained in IAS 12 is as follows:

> *"Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences."*
>
> *"Deferred tax assets are amounts of income taxes recoverable in future periods in respect of deductible temporary differences, together with the carryforward of unused tax losses and tax credits."*

The temporary difference is defined as follows:

> *"Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. ……………………….."*

The definition of tax base, contained in IAS 12 is as under:

> *"The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes."*

Further, in accordance with paragraph 51 of IAS 12, the deferred tax is measured by reference to the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of the asset or liability to which it relates.

With regard to the enquired scenario the Board would also like to refer to the Institute's Accounting Technical Release (ATR) 27 – *IAS 12 'Income Taxes'* which also provides guidance on the accounting of deferred taxes accounting.

The Board understands that the deferred tax accounting does not apply to those companies whose entire income is subject to deduction of tax at source that is taken as a final tax liability (under any provision of the Income Tax Ordinance, 2001), as there will be no temporary differences.

Conversely, the deferred tax accounting is applicable to those companies whose income is of such nature that it is subject to final tax liability as well as normal tax liability in accordance with the applicable taxation laws. Further, if there is uncertainty about the ratio of income subject to final tax liability and normal tax liability (expected local and export sales) in the future years, a reasonable estimate for sales relating to the normal tax liability (local sales) should be made for the future years and the deferred tax liability provided accordingly.

The tax base is of fundamental relevance in the deferred tax accounting, and accordingly, should be determined with reference to the enquired scenario.

(October 02, 2017)

1.3 Complete set of financial statements for small-sized companies

Enquiry:

Section 2 (33) of the Companies Act, 2017, include statement of other comprehensive income, statement of changes in equity and statement of cash flow in the definition of the financial statements. This section applies to all companies whether small-sized, medium-sized or large-sized.

On the other hand, section 1.2 of the 'Revised Accounting and Financial Reporting Standard for Small-Sized Entities', states that the minimum set of financial statements includes (a) Statement of Financial Position, (b) Income Statement and (c) Accounting Policies and explanatory notes. Since the law overrides the accounting standards, it transpires that the Small-Sized Companies will have to prepare the financial statements as defined in the Companies Act, 2017.

Opinion:

The Board would like to draw your attention to section 2(33) of the Companies Act, 2017 which defines financial statements as follows:

"Financial statements in relation to company, includes:

- *a) statement of financial position as at the end of the period*
- *b) a statement of profit or loss and other comprehensive income or in the case of a company carrying on any activity not for profit, an income and expenditure statement for the period;*
- *c) a statement of changes in equity for the period;*
- *d) a statement of cash flows for the period;*
- *e) notes, comprising a summary of significant accounting policies and other explanatory information;*
- *f) comparative information in respect of the preceding period; and*
- *g) any other statement as may be prescribed."*

The above definition is general and all-encompassing, whereas the third schedule of the Companies Act, 2017 specifies the framework to be followed by an entity.

Further, section 1.2 of the *'Revised Accounting and Financial Reporting Standard for Small-Sized Entities' (Revised AFRS for SSEs)*, states that the minimum set of financial statements includes:

a) Statement of Financial Position
b) Income Statement and
c) Accounting policies and explanatory notes.

Based on the above definition of financial statements and requirements of section 1.2 of the Revised AFRS for SSEs, the financial statements prepared in accordance with the Revised AFRS for SSEs shall contain the statements mentioned in such standard only.

(October 02, 2017)

1.4 Deferred tax liability arising on revaluation of fixed assets

Enquiry:

Our client, a Small-Sized Company, had revalued its fixed assets upwards few years back. As you would be aware that the previous '*Accounting and Financial Reporting Standard for Small-Sized Entities (AFRS for SSEs)' did* not cover taxation, therefore our client took guidance from the '*Accounting and Financial Reporting Standards for Medium-Sized Entities*' issued by the ICAP as allowed under section 22 of the *AFRS for SSEs*, and provided deferred tax liability out of the revaluation surplus.

Now section 17.1 of the revised *AFRS for SSEs* does not allow recognition of deferred tax as it says that 'an entity shall apply the taxes payable method to account for its income tax', so should our client transfer the deferred tax liability to revaluation surplus now or as far as tax effects of revaluation are concerned it can carry on the deferred tax liability and make subsequent transfers upon charging of incremental depreciation and realization of revaluation surplus?

Opinion:

The companies are required to prepare financial statements in accordance with the prescribed financial reporting framework.

In accordance with the third schedule of the Companies Act, 2017, the prescribed financial reporting framework for small-sized companies is the AFRS for SSEs.

With regard to accounting and presentation of taxation, section 17 '*Taxation'* of the AFRS for SSEs allows only the taxes payable method and also mentions that the entity only reports current income tax as an expense.

Relevant section 17.1 of the AFRS for SSEs is reproduced as under:

> *"An entity shall apply the taxes payable method to account for its income taxes. The taxes payable method is a method of accounting under which an entity reports as an expense only the current income taxes for that period, determined in accordance with the Tax Law."*

With reference to the scenario explained in the enquiry, a small-sized company preparing financial statements in accordance with the AFRS for SSEs is required to comply with all the requirements of said standard, and apply the transitional provisions contained in section 22 of the AFRS for SSEs. Relevant part is reproduced hereunder:

> *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." (Underline is ours)

Accordingly in the enquired scenerio, a company preparing financial statements in accordance with the AFRS for SSEs is required to de-recognise the deferred tax liability and account for the impact in the opening balance sheet in accordance with the above paragraph of section 22.

(October 02, 2017)

1.5 Presentation of surplus on revaluation of fixed assets

Enquiry:

Based on our understanding, the new Companies Act, 2017 does not specify any treatment for surplus on revaluation of fixed assets. However, if we look in the applicable accounting standards, they specify different disclosure requirements for medium-sized and small-sized companies. Section 17.15C of IFRS for SMEs states that:

"the increase shall be recognized in other comprehensive income and accumulated in equity under the heading of revaluation surplus".

On the other hand, section 2.9 of the 'Revised *Accounting and Financial Reporting Standard for Small-Sized Entities (AFRS for SSEs)'* states that:

"the increase shall be credited directly to the Surplus on Revaluation of Fixed Assets and disclosed in the Statement of Financial Position after Capital and Reserves".

Please clarify, can the surplus on revaluation, in case of small-sized companies, be shown under the heading of equity after capital and reserves or it will have to be shown outside equity as was the previous legal requirement?

Opinion:

The Board would like to highlight that the specific section relating to the surplus on revaluation of fixed assets (section 235 of the repealed Companies Ordinance, 1984) has not been carried forward in the Companies Act, 2017.

Consequently, the accounting treatment and presentation of the surplus on revaluation of fixed assets shall be in accordance with the applicable accounting and reporting standards (i.e. IFRS,

IFRS for SMEs, AFRS for SSEs) whereby the surplus on revaluation will be presented under equity.

It is to be noted that the fifth schedule of the Companies Act, 2017 requires the revaluation surplus on property, plant and equipment to be disclosed as a separate line item on the face of the financial statements.

(October 02, 2017)

1.6 Definition of 'executives'

Enquiry:

Paragraph IV B of Part 1 to the fourth schedule to the Companies Act, 2017 defines "executive" as an employee, other than the chief executive and directors, whose basic salary exceeds twelve hundred thousand rupees in a financial year, for the purposes of disclosure required under paragraph VI 35 of the fourth schedule. Similarly, disclosures also have to be given for executives under paragraph V 29 of the fifth schedule to the Act, but the term 'executive' has not been defined in that Schedule.

Opinion:

Your attention to the following wordings of the fifth schedule of the Companies Act, 2017, which clearly states if an expression is defined in the fourth schedule it shall have the same meaning thereby the meaning of 'executive' will be same for both the schedules:

> *"Any word or expression used herein but not defined in the Act and/or fourth schedule shall have the same meaning as under the applicable Accounting Framework"*.

Accordingly, the definition of executive contained in the fourth schedule of the Companies Act, 2017 will be relevant for the fifth schedule disclosure requirements.

(October 02, 2017)

1.7 Classification of companies under the third schedule of the Companies Act, 2017

Enquiry:

In paragraph 2 (a) of the third Schedule of the Companies Act, 2017, three conditions for a company to be classified as large sized company are given and after first two conditions word 'or' has been used, which clearly indicates that if anyone of the three conditions applies, the company will be large sized company. In paragraphs No. 3(a), 3(b) and 4 the words 'or' or 'and' have not been used, which creates a confusion that all or anyone of the given conditions are to be applied for a company to be a medium-sized company or small-sized company. SRO 929(1)2015 appropriately used these words for the classification of companies, but third schedule creates confusion. Please clarify.

Opinion:

The Board would like to highlight that under the Companies Act, 2017 the classification criterion has been re-defined/ revised, compared to the repealed Companies Ordinance, 1984 (through SECP SRO 929 of 2015).

We note that the wording "or" is inadvertently missing from the classification criteria for the medium-sized, private company under clause 3 (b). Further, the applicable accounting framework has erroneously been stated as Revised AFRS for SSEs whereas it should be International Financial Reporting Standards for SMEs.

The absence of wording “and” in the classification criteria for the small-sized company in clause 4 of Third Schedule is not relevant as all conditions are to be fulfilled for classification as a small-sized company. If anyone of the condition is not fulfilled the company will be classified as a medium-sized company.

(October 02, 2017)

1.8 Filing of financial statements with the registrar of companies

Enquiry:

Section 233(3) of the Companies Act, 2017 exempts private companies having paid up share capital not exceeding ten million rupees from filing of financial statement with the Registrar of Companies. On the other hand section 234 requires private companies having paid up share capital not exceeding one million rupees to file their financial statements with the Registrar.

It transpires that all companies have to file their financial statements with the Registrar of Companies, except private companies having paid up share capital more than one million rupees but not more than ten million rupees. We do not understand the logic to require micro companies to file their financial statements whether audited or unaudited and to exempt the sufficient larger companies having capital up capital up to ten million rupees, from filing of the financial statements.

Opinion:

The provisions relating to the audit and filing of financial statements by the companies have been prescribed in section 233 and 234 of the Companies Act, 2017. The filing related requirements are that:

- A private company with share capital less than 1 million is required to file authenticated financial statements (whether audited or not) with the registrar within thirty days from holding of meeting. (section 234)

- On the other hand, a private company having share capital not exceeding 10 million rupees is not required to file the financial statements with the registrar. (section 233)

We have noted that the above provisions need to be rationalised, as micro/ very small companies (share capital less than one million) have been directed to file their financial statements. Whereas, comparatively large sized companies (having share capital up to ten million rupees) are not mandatorily required to file their financial statements. Further, the Institute has highlighted this anomaly to SECP also.

(October 02, 2017)

1.9 Reconciliation of property, plant and equipment

Enquiry:

Section 17.31 of the IFRS for SMEs requires a reconciliation of the carrying amount at the beginning and end of the reporting period showing additions, disposals, depreciation, etc. in respect of property, plant and equipment, and specifically states that this reconciliation need not be presented for prior periods.

On the other hand the section 2.18 of the Revised *'Accounting and Financial Reporting Standard for Small-Sized Entities' (Revised AFRS for SSEs*) is silent about the presentation of the reconciliation for the prior years. So should we presume that this reconciliation need not be presented for the prior periods? We understand that small-sized entities cannot be overburdened for more disclosure in contrast to medium-sized entities.

Opinion:

Section 1.10 of the Revised AFRS for SSEs requires that the entity shall disclose comparative information in respect of the previous comparable period for all amounts presented in the current period's financial statements.

Further, section 2.18 of the Revised AFRS for SSEs outlines the requirement to present reconciliation of the property plant and equipment. A specific provision allowing the companies not to present the reconciliation for the comparative period is not contained in section 2.18. In this regard it is pertinent to mention that a specific line is included in section 3.9 relating to intangible assets, reproduced hereunder:

> *"This reconciliation need not be presented for prior periods".*

The requirements of section 1.10 and 2.18 read together require the presentation of reconciliation of the property, plant and equipment for the current and comparative period.

(October 02, 2017)

1.10 Presentation of investment property

Enquiry:

Sections 4.2(ea) and 4.2(f) of IFRS for SMEs states that "investment property carried at cost less accumulated depreciation and impairment" and "investment property at fair value through profit or loss" respectively, should be shown as line items on the statement of financial position.

Our question is that should the complete nomenclature as mentioned herewith be shown on the statement of financial position together with the amounts of accumulated depreciation and impairment, or an abbreviated name can be shown on the face of the statement of financial position and amounts of depreciation and impairment be given in the notes?

Opinion:

Section 4.2 of the IFRS for SMEs lists down minimum line items, to be presented, in the statement of financial position. The relevant part of section 4.2 of the IFRS for SMEs is reproduced hereunder:

> *"4.2 As a minimum, the statement of financial position shall include line items that present the following amounts:*
>
> *(a) ......*
> *(ea)* ***investment property*** *carried at cost less accumulated depreciation and impairment".*

Section 16 of the IFRS for SMEs deals with investment property and section 17 of the IFRS for SMEs deals with the property, plant and equipment. However, section 17.31 contains the disclosure requirements relating to property, plant and equipment and investment property carried at cost. Therefore, the disclosure requirements of investment property carried at cost less accumulated depreciation and impairment are set out in section 17 of the IFRS for SMEs.

Section 17.31 requires that:

> *"An entity shall disclose the following for each class of property, plant and equipment determined in accordance with paragraph 4.11(a) and **separately for investment property carried at cost less accumulated depreciation and impairment**:*
>
> *a) the measurement bases used for determining the gross carrying amount;*
>
> *(b) ………………..;*
>
> *(e) <u>a reconciliation of the carrying amount at the beginning and end of the reporting period showing separately</u>:*
> *(i) additions;*
> *(ii) disposals;*
> *(iii) acquisitions through business combinations;*
> ……………………………………………………………………………
> *(vii) depreciation; and*
> *(viii) other changes.* *(Underline is ours)*

Based on the above, the net amount of investment property carried at cost shall be presented in the statement of financial position, and the reconciliation of opening and closing carrying amounts, including depreciation charge and impairment shall be disclosed through the notes to the financial statements.

From the above provisions of IFRS of SMEs, it is apparent that net amount of investment property will be presented on the face of the statement of financial position. The depreciation charge and impairment with reconciliation of opening and closing amounts will be disclosed through the notes.

(October 02, 2017)

1.11 Transition to the Revised AFRS for SSEs and IFRS for SMEs

Enquiry:

The 'Revised Accounting and Financial Reporting Standard for Small-Sized Entities', requires retrospective adoption of the standard by amending the comparative financial statements, whereas, section 35.2 of IFRS for SMEs allows both retrospective and prospective adoption. Please clarify.

Opinion:

The Board would like to draw your attention to section 35.2 of IFRS for SMEs which states:

"35.2 <u>An entity that has applied the IFRS for SMEs in a previous reporting period, but whose most recent previous annual financial statements did not contain an explicit</u>

<u>and unreserved statement of compliance with the IFRS for SMEs, must either apply this section or apply the IFRS for SMEs retrospectively</u> in accordance with Section 10 Accounting Policies, Estimates and Errors as if the entity had never stopped applying the IFRS for SMEs. When such an entity does not elect to apply this section, it is still required to apply the disclosure requirements in paragraph 35.12A in addition to the disclosure requirements in Section 10." (underlining is ours)

Section 35 of the IFRS for SMEs outlines the procedures for preparing financial statements at the date of transition. The treatment for most items is retrospective and only for certain items is prospective such as specified below:

"35.9 On first-time adoption of this Standard, an entity shall not retrospectively change the accounting that it followed under its previous financial reporting framework for any of the following transactions:

(a) derecognition of financial assets and financial liabilities. -------------------------
(b) hedge accounting --------------
(c) accounting estimates.
(d) discontinued operations"

Section 22 *'Transition to the Accounting Standard SSEs'* of the '*Revised Accounting and Financial Reporting Standard for Small-Sized Entities' (Revised AFRS for SSEs*) states that:

"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."

From the above it is clear that for transition to the Revised AFRS for SSEs the retrospective approach will be followed.

(October 02, 2017)

1.12 Definition of associated company

Enquiry:

IAS 28 *'Investments in Associates and Joint Ventures'* defines an associate as an entity over which the investor has significant influence. Significant influence has also been described as holding, directly or indirectly 20 per cent or more voting power in the investee.

Section 2 (4) of the Companies Act, 2017 gives four situations for a company to be an associated company:

(I) if a person holds not less 20% of the voting power in two companies, these two companies shall be associates for each other;
(2) if the companies are under common management or control or one is the subsidiary of another;
(3) managed modaraba; and
(4) if a person holds not less than 10% of the voting power in a company, he shall be an associated person of another person who also holds not less than 10% voting power in that company.

Our question is that, why has the situation of directly holding not less than 20% voting power not been mentioned in the law? Does it mean an investor holding 20% voting power in the investee is not an associate? More over the term 'common management' has also not been described. Please elaborate.

Opinion:

In relation to the accounting of associated companies, a new provision has been incorporated in section 225 of the Companies Act, 2017 through which the associated companies will be accounted for in the financial statements in accordance with the IFRS definition.

It is to be noted that the definition of the 'Associated Company' contained in section 2(4) of the Companies Act, 2017 is relevant and applicable to all other regulatory matters under the Companies Act, 2017.

(October 02, 2017)

1.13 Applicability of two options for the medium sized companies

Enquiry:

Your kind attention is drawn towards provisions of SRO 929 (I)/ 2015 dated 10 September 2015. At serial No. 3 the IFRS for SMEs were made applicable for medium sized companies. In column No. 4 of the above SRO the following is mentioned:

> *"A Medium-Sized Company with appropriate disclosure in its financial statements may have option to adopt the following:*
>
> *(i) The revaluation model included in the IAS – 16, 'Property, Plant and Equipment'; and*
>
> *(ii) The capitalizing of borrowing costs as permitted by IAS - 23, 'Borrowing Costs'".*

The third schedule of the Companies Act, 2017 as amended up to date vide SRO 1169(I)/2017 dated 7 November, 2017 does not include the above mentioned clarification as included in SRO 929(I)/2015 allowing the medium-sized companies to adopt revaluation model and to capitalize the borrowing costs as mentioned in (i) and (ii) above respectively.

You are requested to please clarify the applicability or otherwise of the above two options for the medium-sized companies under the third schedule of the Companies Act, 2017.

Opinion:

The International Accounting Standards Board (IASB) issued the IFRS for SMEs in July 2009. In

Pakistan, the Securities and Exchange Commission of Pakistan (SECP) through S.R.O 929(I)/2015 (dated September 10, 2015) prescribed the IFRS for SMEs as the financial reporting framework for medium-sized companies. However, under S.R.O 929(I)/2015 two modifications were made in the IFRS for SMEs. These modifications are reproduced as under:

> *"A medium sized company with appropriate disclosure in its financial statements may have the option to adopt the following:*
>
> a. *The revaluation model included in the International Accounting Standard (IAS) 16 'Property, Plant and Equipment'.*
>
> b. *The capitalizing of borrowing cost as permitted by International Accounting Standard (IAS) 23 'Borrowing Cost'."*

It is to be noted that in 2015 IFRS for SMEs were amended by IASB. Amongst the incorporated amendments was addition of revaluation model in relation to the property, plant and equipment. Relevant paragraph 17.15 of section 17 (Property, plant and equipment) of IFRS for SMEs (2015 version) is reproduced hereunder:

> *"An entity <u>shall choose either the cost model in paragraph 17.15A or the revaluation model in paragraph</u> 17.15B as its accounting policy and shall apply that policy to an entire class of property, plant and equipment. ……………." (Underline is ours)*

Pursuant to the above amendment in the IFRS for SMEs the only modification/ difference between the IFRS for SMEs issued by IASB and financial reporting framework prescribed by SECP through S.R.O 929 (I)/ 2015 related to the borrowing costs.

IFRS for SMEs require that all borrowing costs are charged to profit or loss, and the relevant paragraph 25.2 of section 25 (Borrowing Costs) of IFRS for SMEs is reproduced hereunder:

> *"An entity shall recognise all borrowing costs as an expense in profit or loss in the period in which they are incurred."*

The Board understands that SRO 929 (I)/ 2015 was issued under the repealed Companies Ordinance, 1984. The Companies Act, 2017 has been enacted on May 30, 2017 and the Board would like to draw your attention to the third schedule of the Companies Act 2017. The Third Schedule of the Companies Act, 2017 specifies that a medium-sized company is required to prepare statutory financial statements in accordance with IFRS for SMEs. However, in the Third Schedule of the Companies Act, 2017 no modification has been prescribed in the IFRS for SMEs.

Based on the above discussion the Board concludes that a medium-sized company in accordance with IFRS for SMEs:

- Can choose either cost model or revaluation model for measurement after initial recognition of property, plant and equipment.

- Shall recognise all borrowing costs as an expense in the statement of profit or loss in the period in which they are incurred.

(January 12, 2018)

1.14 Guidance on presentation of discount to customers in financial statements

Enquiry:

This query is being made in order to eliminate the diversity in practice as a result of the newly promulgated auto policy 2016 for auto industry. The auto policy *inter alia* states that:

> *"Advance payment shall be limited up to 50% of the total price. Price and delivery schedule, not exceeding two months, shall be firmed at the time of booking. Any delay over two months shall result into discount @ KIBOR +2 percent prevailing on date of final delivery / settlement of the final payment, which shall help shorten the lead time."*

In this background, guidance is requested regarding the presentation of this discount as to whether this discount should be presented as a deduction from sales revenue or should it be presented as a finance cost?

Opinion:

Revenue is derived from contracts with customers entered into by an entity for the sale of goods or services, in the ordinary course of the business. The automotive manufacturer's financial liability (discount payable to the customer due to delayed delivery of vehicle) originates from a contract (for the sale of vehicle) with the customer.

IFRS 15 '*Revenue from Contracts with Customers'* applies to contracts to deliver goods or services. The core principle of IFRS 15 is that an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

IFRS 15 provides detailed guidance on the determination of the consideration to which the entity expects to be entitled in exchange for those goods or services (the transaction price).

Relevant paragraph of IFRS 15 is reproduced here under:

> *"An entity shall <u>consider the terms of the contract</u> and its customary business practices to determine the transaction price. <u>The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer</u>, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, <u>variable amounts</u>, or both."* (Underline is ours)

In determining the transaction price the entity considers the guidance related to the variable consideration, significant financing component, non-cash consideration and consideration payable to the customer, contained in IFRS 15.

Therefore, in the enquired scenario the automotive manufacturer should recognise and present revenue in accordance with the requirements of IFRS 15.

(February 1, 2018)

1.15 Revenue recognition from insurance brokerage

Enquiry:

We recognise revenue from consultancy and brokerage services on later of billing date or effective date of underlying policy. We recognise revenue in light of the example 17 para 23A.21 of IFRS for SMEs which states that revenue are recognized on the effective date of commencement or renewal of the related policies, if the agent is not required to render further service, otherwise the commission or part thereof is deferred and recognized as revenue over the period which the policy is in force.

The rationale for later of billing date or effective date of underlying policy is due to the fact that amount of revenue can be measured reliably at that point in time.

We understand that insurance contracts are considered ‘uberrima fides’ that is correct of utmost good faith and the only thing available is a policy document which undertakes that on happening of an event, which cannot be predicted, the insured will be indemnified.

Since the probability to render further services is not measurable therefore the revenue is recognized at later of billing date or the effective date of underlying policy.

Additionally, as we record the revenue at the later of effective date of insurance policy or invoice date, exchange gains or loss arising on foreign currency denominated invoices are not recorded for services that fall between more than one financial years as revenue is recognized on the invoice date only instead of stage of completion method.

You are requested to please guide us which policy to follow.

Opinion:

Paragraph 23.14 of section 23 of IFRS for SMEs provides guidance on the revenue recognition from rendering of services. The paragraph is reproduced as under (underline is ours):

> *“<u>When the outcome of a transaction involving the rendering of services can be estimated reliably, an entity shall recognise revenue</u> associated with the transaction by reference to the stage of completion of the transaction at the end of the reporting period (sometimes referred to as the percentage of completion method). The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:*
>
> *a) the <u>amount of revenue can be measured reliably</u>;*
> *b) it is probable that the economic benefits associated with the transaction will flow to the entity;*
> *c) the <u>stage of completion of the transaction at the end of the reporting period can be measured reliably</u>; and*
> *d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.”*

Further, paragraph 23.15 provides guidance on the revenue recognition in cases:

- where services are performed by an indeterminate number of acts over a specified period of time; or
- when a specific act is much more significant than any other act.

Accordingly, it is to be noted that the revenue recognition example related to insurance agency commission (quoted in paragraph 23A.21 of IFRS for SMEs Standard) is based on the basic premise that all revenue recognition requirements (contained in paragraph 23.14) have been fulfilled.

The revenue from rendering of services is generally recognised on the performance of the services, under the terms of the agreement. Further, generally its recognition is based on the performance of the service and not to the billing arrangement.

Generally, the revenue from insurance brokerage commission would be recognized when the performance obligation is satisfied (effective date of the policy or upon completion of a milestone).

Further, paragraph 30.7 states that:

> *"An entity shall record a foreign currency transaction, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.*

Based on the above discussion, the Board is of the view that:

- Revenue from the consultancy and brokerage services earned under the terms of agreement(s), in accordance with the principle set out in paragraph 23.14 of IFRS for SME Standards.

- The foreign currency transactions (revenue from the consultancy and brokerage services), in accordance with the paragraph 30.7 of IFRS for SMEs Standard.

- The gain on loss on the foreign currency revenue related monetary assets, in accordance with the principle outlined in paragraph 30.10 of IFRS for SME Standards.

(March 12, 2018)

1.16 Accounting for financial assets at fair value through profit or loss in accordance with IAS 39 '*Financial Instruments: Recognition and Measurement*'

Enquiry:

Technical advice is sought on the following matters:

A. A Public Interest Company has made investments in listed securities and has categorized such investments at fair value through profit or loss in accordance with IAS 39 '*Financial Instruments: Recognition and Measurement*'. Explanation is required in respect of recognising gain or loss on disposal of investments in profit or loss with the following scenario:

Script "A" is purchased at Rs. 80 during the year 1 (transaction cost is charged to profit & loss account separately) and have market price at year end at Rs. 100 per share. The Company has recongised Rs 20 gain in profit and loss account as "unrealized gain on investments at fair value through profit & loss" and debited its investment account. In subsequent year 2, the Company has disposed of its investment at Rs. 110. What would be correct accounting treatment in case of disposal in year 2?

a. The company will recognise gain of rupees 10 in profit and loss account as "Gain on disposal of investments" or

b. The company will recognise gain on disposal of securities at Rs. 30 (difference between the original cost of Rs. 80 and the sale price i.e. Rs. 110) in year 2 and reverse the gain of Rs. 20 previously recongised as "Unrealized gain or loss on investments available for sale" in year 2.

B. Is the Company is required to disclose the list of all investments (individually name wise - scripts) made in marketable securities or aggregate value of such securities is sufficient under the Companies Act, 2017 and IAS 39?

C. IFRS 9 - Financial instruments is required to be adopted for financial statements beginning on or after July 1, 2018. What would be the treatment of reserve created for "Investments available for sale" which is created in accordance with IAS 39 as IFRS 9 is required to recognize gain or loss on "Non-Trading Investments" to Other Comprehensive Income (OCI) instead of fair value reserve in equity?

Opinion:

The Board views on the subject enquiries are as under:

Enquiry A

The financials assets at fair value through profit or loss are measured at fair value at each reporting date, until derecognition of such assets. The gains and losses arising from the changes in the fair value are included in the statement of profit or loss in the period in which they occur.

Further, the accounting for derecognition of financial assets, including financial assets at fair value through profit or loss is explained in paragraph 26 of IAS 39 (reproduced as under):

"On derecognition of a financial asset in its entirety, the difference between:

a. the carrying amount and

b. the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income shall be recognised in profit or loss."

Based on the above requirement of IAS 39, in the enquired scenario following accounting treatment would be followed:

- **In year 1:** Recognise unrealized gain of Rs. 20 arising from the change in fair value of investment i.e. difference between the acquisition of investment of Rs. 80 and year end fair value of investment of Rs. 100. The fair value of Rs. 100 would be the carrying value of the investment at the end of year 1.

- **In year 2:** Recognise the realized gain of Rs. 10 which is the difference between the carrying amount of investment of Rs. 100 and the consideration received of Rs. 110.

Enquiry B

The disclosure requirements for financial instruments are contained in IFRS 7 '*Financial*

Instruments: Disclosures'.

In context of the enquiry, paragraph 8 of IFRS 7 requires disclosure of carrying amount of categories of financial assets and liabilities. Under the Companies Act, 2017, the financial statements disclosure requirements are prescribed in the fourth and fifth schedules. The investment related disclosures relate to investments made in foreign companies and associated companies.

The Board is of the view that the detailed listing of all investments (individually name wise-scripts) made in marketable securities is not prescribed under IFRS 7 and under the Companies Act, 2017.

Enquiry C

IFRS 9 '*Financial Instruments'* will replace the multiple classification and measurement models for financial assets of IAS 39. In context of the enquiry, under IFRS 9 a previously classified 'available for sale' (AFS) financial asset can be categorized either as 'financial asset measured at fair value through other comprehensive income' (FVOCI) or financial asset measured at fair value through profit or loss' (FVPL).

The accounting of FVOCI and FVPL under IFRS 9 in comparison to IAS 39 is summarized below:

- **FVOCI -** An equity instrument classified as AFS under IAS 39 may be irrevocably designated upon initial application of IFRS 9 as FVOCI. In this case, the recognition and presentation of gain or loss of this instrument is same under IFRS 9 and IAS 39. The unrealized gain or loss on such instrument is recognized in other comprehensive income and the cumulative gain is reported as a separate component of equity. However, under IFRS 9 this unrealized accumulated gain (presented as a separate component of equity) cannot be reclassified to profit and loss on disposal of FVOCI asset. However, it can be transferred within equity (i.e. between the FVOCI reserve and retained earnings).

- **FVPL -** Upon initial application of IFRS 9, if 'available for sale' equity instrument under IAS 39 is classified as 'financial asset measured at fair value through profit or loss', the change shall be accounted for under paragraph 7.2.1 of IFRS 9 retrospectively, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

(April 17, 2018)

1.17 Capitalization of exchange differences on recent acquisition of inventories

Enquiry:

Can foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency be capitalized in cost of inventory?

Opinion:

The Board notes that guidance should be obtained from IAS 2 '*Inventories'* and IAS 21 '*The Effects of Changes in Foreign Exchange Rates'*.

The cost of inventories should be determined in accordance with IAS 2 and the accounting of inventory whose costs of purchase is denominated or requires settlement in a foreign currency should be done in accordance with IAS 21.

IAS 2 requires that inventories should be measured at lower of cost or net realizable value. The cost comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Costs of purchase include purchase price, import duties, handling and transportation costs. However, as explained previously in introduction paragraph IN 10 of IAS 2, the exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency are not permitted to be included in the cost of purchase of inventories.

In addition to IAS 2, the principles outlined in IAS 21 for the recognition and measurement of foreign currency transactions can also be considered in respect of the inventory (whose purchase price is denominated or requires settlement in a foreign currency).

In accordance with paragraphs 21 and 22 of IAS 21, a foreign currency transaction is initially recorded at the spot exchange rate between the functional currency and the foreign currency, prevalent at the date of the transaction. The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with IFRS. The date of transaction for the inventories is generally the date on which risks and rewards of ownership are transferred to the buyer.

Further, in accordance with the paragraph 23 of IAS 21, re-translation is not required at the subsequent reporting date/s for the foreign currency based non-monetary assets that are measured at historical cost. Accordingly, inventory is not required to be re-translated as it is a non-monetary asset measured at historical cost.

In context of the enquiry, it is relevant to mention that the term "recent acquisition" was used in SIC 11 '*Foreign Exchange-Capitalisation of Losses from Severe Currency Devaluations*' (which has been superseded by IAS 21). Further, in SIC 11 the term "recent acquisition" referred to the acquisitions within twelve months prior to the severe devaluation or depreciation of the reporting currency.

Based on the above discussion, the Board is of the view that inventory whose cost is denominated or requires settlement in a foreign currency should be:

- Initially recognised using the foreign currency exchange rate at the date of transaction i.e. the date of transfer of risks and rewards of ownership of inventory;

- The exchange differences arising directly on the 'recent acquisition' of inventories invoiced in a foreign currency should not to be included in the cost of purchase of inventories; and

- The inventory measured at cost should not be subsequently re-measured for changes in exchange rate. Resultantly the subsequent changes in the exchange rate would not be capitalised in the cost of inventory.

(April 20, 2018)

1.18 Accounting of promotional/ marketing items

Enquiry:

With regard to pharmaceutical manufacturing companies, your clarification is required about the accounting of promotional/ marketing items that are left undistributed at year end e.g., fridge, air-conditioner, watches, drafting pads etc. Some pharmaceutical companies are classifying these items as their current assets under stores and spares heading. Is this treatment correct? Or should these undistributed items be expensed out as well in the year of purchase, being non asset?

It is important to note that there are no written terms and conditions. These items are distributed as gifts to doctors under implied consideration that they will refer the medicine of pharmaceutical company to their patients.

Opinion:

The Board would like to highlight that the enquired matter has been deliberated by the International Financial Reporting Interpretations Committee (IFRIC) in its meetings and the IFRIC decision based on IAS 38 '*Intangible Assets'* is as under:

> *"Paragraph 5 of IAS 38 states that IAS 38 applies to expenditure on advertising activities. Accordingly, the Committee concluded that if an entity acquires goods solely to be used to undertake advertising or promotional activities, it applies the requirements in paragraph 69 of IAS 38. Paragraph 69 requires an entity to recognise expenditure on such goods as an expense when the entity has a right to access those goods. Paragraph 69A of IAS 38 states that an entity has a right to access goods when it owns them. The entity, therefore, recognises expenditure on those goods as an expense when it owns the goods, or otherwise has a right to access them regardless of when it distributes the goods."*

In explaining the rationale for the requirements in paragraph 69, paragraph BC46B of IAS 38 states that goods acquired to be used to undertake advertising and promotional activities have no other purpose than to undertake those activities. In other words, the only benefit of those goods for the entity is to develop or create brands or customer relationships, which in turn generate revenues. However, applying IAS 38, the entity does not recognise internally generated brands or customer relationships as assets.

IFRIC decision on the enquiry can be accessed in the IFRIC update at:
http://www.ifrs.org/news-and-events/updates/ifric-updates/september-2017/#8

In view of the IFRIC decision, the Board has accordingly concluded that in the enquired scenario the promotional and marketing goods (refrigerators, air conditioners etc.) should be recognised as an expense in the statement of profit of loss, in accordance with IAS 38. The expense should be recorded when the pharmaceutical company has right to access to those goods, regardless of when those promotional and marketing goods are distributed to the doctors.

(April 20, 2018)

AUDITING

2.1 Query on statutory positions

Enquiry:

Mr. ZAMS is a qualified Chartered Accountant and holds following positions in a same group:

- Head of Internal Audit, Risk and Compliance in a Listed Modaraba, (on its payroll, dedicated function);
- Head of Internal Audit (acting as coordinator to a outsourced auditor's firm) of an Investment Bank;
- Head of Internal Audit (acting as coordinator to a outsourced auditor's firm) and Compliance Officer of a brokerage house; and
- Head of Internal Audit (acting as coordinator to an outsourced auditor's firm) of an asset management fund and its three associated funds.

Does COCG allow one person to hold multiple statutory positions?

Opinion:

The Committee considered the requirements given in the Code of Corporate Governance, 2012 (the Code) and the requirements given in the Companies Act, 2017.

The Code

The revised ICAP Code of Ethics for Chartered Accountants 2015 (the Code of Ethics) 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 chartered accountants to enable them to perform their functions without bias, conflict of interest or undue influence.

Your attention is drawn to the following sections of Part C of the Code of Ethics relating to Chartered Accountants in Business:

300.6 A chartered accountant in business shall not knowingly engage in any business, occupation, or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the fundamental principles.

310.1 A chartered accountant in business 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 becreated when:

- *The chartered accountant undertakes a professional activity related to a particular matter for two or more parties 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 a party for whom the chartered accountant undertakes a professional activity related to that matter are in conflict.*

A party may include an employing organization, a vendor, a customer, a lender, a shareholder, or another party.

A chartered accountant shall not allow a conflict of interest to compromise professional or business judgment.

310.3 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 business shall exercise professional judgment and be alert to all interests and relationships that 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 might compromise compliance with the fundamental principles.

In view of the above, the Committee is of the view that the Head of Internal Audit of one group company of a listed company can hold similar position in any other listed company of the same group, only where independence is not impaired and conflict of interest is not created while performing his/her statutory responsibilities with the other role.

Further, appropriate safeguards should be applied, when necessary, to eliminate the threats to compliance with the fundamental principles created by the conflict of interest or reduce them to an acceptable level.

The Companies Act, 2017

You are advised to ensure compliance, to the extent applicable in your case, with the related definitions and sections of the Companies Act, 2017 which have been reproduced below for reference: (underline is ours)

2(45) ***"officer"*** *includes any director, chief executive, chief financial officer, company secretary or other authorised officer of a company;*

206. ***Interest of officers****. (1) Save as provided in section 205 in respect of directors, no other officer of a company who is in any way, directly or indirectly, concerned or interested in any proposed contract or arrangement with the company shall, unless he discloses the nature and extent of his interest in the transaction and obtains the prior approval of the board, enter into any such contract or arrangement.*

(2) ………………………

208. ***Related party transactions****. (1) A company may enter into any contract or arrangement with a related party <u>only in accordance with the policy approved by the board</u>, subject to such conditions as may be specified, with respect to-*

a) to e) ……………………………
f) such related party's appointment to any office or place of profit in the

company, its subsidiary company or associated company:

Provided that where majority of the directors are interested in any of the above transactions, the matter shall be placed before the general meeting for approval as special resolution:

***Explanation.**- In this sub-section:*

*(a) the expression "**office of profit**" means any office:*

(i) ……………
(ii) where such office is held by an individual other than a director or by any firm, private company or other body corporate, if the individual, firm, private company or body corporate holding it receives from the company anything by way of remuneration, salary, fee, commission, perquisites, any rent-free accommodation, or otherwise;

*(c) the expression "**related party**" includes-*

(i) a director or his relative;
(ii) a key managerial personnel or his relative;………………

(July 07, 2017)

2.2 Suggestion by professional firm

Enquiry:

The Committee's valuable guideline & advice is required on the following matters:

1. Can we issue written professional advice on basis of discussion with the other side concerned/ advised?
2. If the CA firm is a partnership firm, shall the suggestions be signed in the personal name of the partner or in the firm's name?
3. If signed in the firm's name, is the name of the signing partner be given or not?

Opinion:

Responses to your queries are as follows:

1. A written professional advice may be issued on the basis of engagement letter signed with the client.

2 & 3. The Companies Act, 2017 and Institute's ATR 19 '*Identification of the Engagement Partner in the Auditors' Report on the Financial Statements/ Interim Financial Information*' outline the requirements to mention the name of the firm and engagement partner in the audit and review reports. The other suggestion/ advice may be issued in the personal name of the partner or in the firm's name.

(September 08, 2017)

2.3 Name of signing partner

Enquiry:

In the audit report, name of the engagement partner is given while signing it in the firm's name. If a letter, suggestion or any paper other than audit report is signed in the firm's name, is it necessary that the name of the partner signing in firm's name to be given?

Opinion:

Where the auditor's report is signed by the partnership firm, the name of the engagement partner is to be mentioned, in accordance with the requirements of the Companies Act, 2017. Further, Institute's ATR 19 '*Identification of the Engagement Partner in the Auditors' Report on the Financial Statements/ Interim Financial Information*' also specifies that the name of the engagement partner shall be mentioned in the audit and review reports.

We understand that it is not necessary to mention in a letter, advice or any other paper the name of the partner signing the document in the firms' name.

(September 08, 2017)

2.4 Signature of auditor's report

Enquiry:

Section 251 of the Companies Act, 2017 states that *'if the auditor is an individual the report must be signed by him'*. A clarification is required, whether a sole-proprietor has to affix his or her personal signatures on the audit report now against the previous practice of signing in the name of the firm.

Opinion:

Your attention is drawn to section 251 of the Companies Act, 2017:

*"251. **Signature of auditor's report.-** (1) The auditor's report must state the name of the auditor, engagement partner, be signed, dated and indicate the place at which it is signed.*

2) Where the auditor is an individual, the report must be signed by him."

Further, ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements,* mentions that:

"A64. The auditor's signature is either in the name of the audit firm, the personal name of the auditor or both, as appropriate for the particular jurisdiction".

The jurisdiction practice is that the report is signed in the name of which the sole proprietor / firm is registered. If the sole proprietor is registered in his name, he will use his name in signing if is registered by his initials such as BH & Co. then will sign using those initials.

(October 02, 2017)

2.5 Record of direct dispatch and direct receipt of third party confirmations

Enquiry:

During our audits third party direct confirmations are sent directly by our staff (on local GPO post) and received in our office in enclosed envelop and dates of send/ receive were mentioned in control sheet. Is there any audit requirement to send them by courier? Also is there any requirement of audit to maintain in and out registers or stamping in and out of the mail is mandatory condition for audit?

Opinion:

The Board would like to draw your attention to Para A4 of ISA 505, *External Confirmations*, which states the factors that need to be considered when designing confirmation request. One of the factors is the method of communication that can be in paper form, or by electronic or other medium. Therefore, ISA 505 does not mandate as part of audit procedure to send third party direct confirmations, only through courier other means like reliable general postage system may also be used.

In case of obtaining bank confirmation guidance is provided under ATR 18 '*Bank Reports for Audit Purposes*'.

Further, with regard to your query on audit requirement to maintain in and out registers or stamping in and out of the mail. This is not an audit requirement but may be firm's internal policy to maintain in and out registers or stamping in and out of the mail for control purposes, as it considers necessary.

(October 02, 2017)

2.6 Public Sector bidding for auditors

Enquiry:

For the purpose of appointment of external auditors for the public sector entity against the tender for the financial year 2017-18, few chartered accountant firms has quoted fee for financial year 2017-18 lower than as charged by our outgoing auditors, our revenue, expenses & balance sheet size has also increased for the financial year 2017-18.

As per ICAP Code of Ethics for Chartered Accountants:

> *"Fee quoted lower than that charged by the chartered accountants in practice previously carrying out the audit be regarded as undercutting."*

You are therefore requested to kindly guide us whether can we avail the professional services for the financial 2017-18 from those chartered accountant firms who have quoted fee lower than as charged by our outgoing auditors or otherwise.

Opinion:

The Committee would like to clarify that the entity making appointment of the auditor is responsible to appoint the auditor in accordance with legal and regulatory provisions applicable to such entity.

It is pertinent to mention that the Code of Ethics for Chartered Accountants (the Code) issued by ICAP applies to the members of the Institute.

Section 240.1 of the Code recognizes that audit fee is a commercial matter to be agreed between the auditor and the appointing entity. When entering into negotiation regarding professional services, an auditor may quote whatever fee is appropriate in commensuration with the nature and service to be rendered. However, the quantum and scope of audit work are important and relevant factors in the determination of auditor's fee. In accordance with requirements of the Code if the scope and quantum of audit work does not materially differ from the work carried out by the previous auditor, the audit fee lower than the fee charged by the previous auditor could be regarded as undercutting.

Based on the information provided in your enquiry the revenue, expenses and financial position of the company has improved/increased from the previous audited year.

In accordance with section 240.1 of the Code, it is not permissible for the incoming auditor to accept an audit engagement at a fee lower than that charged by the previous year external auditor unless the scope and quantum of audit work has reduced compared to the previous audited year. However, the provision of the relevant information (such as the fee being charged by the previous auditor, the scope and quantum of work, the changes in scope and quantum of work etc.) by the appointing entity, prior to the submission of the proposal, to the proposing auditor for determining/ quoting audit fee is also to be given consideration.

It is advisable that the appointing entity's management or those charged with governance may engage in a dialogue with the proposed auditor(s) to ensure that the auditor(s) have the complete information (such as the previous year audit fee, quantum and scope of the current year's audit work etc.), necessarily required for the determination of the audit fee. This approach will help in avoiding any miscommunication and/or misunderstanding in relation to the determination and agreement of audit fee. Accordingly, the reporting entity may proceed in the matter in accordance with the guidelines provided by section 240.1 of the Code, the legal and regulatory provisions and the procurement policies and rules applicable in the circumstances.

(May 09, 2018)