The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

# Topic wise Selected Opinions

# IFRS 9 & IAS 39: Financial Instruments

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## 1. Objective evidence of impairment on an amount due from the Government of Pakistan under the circular debt situation

### Brief facts of the enquiry

The Accounting Standards Board (the Board) received an enquiry, wherein, guidance was sought that whether the historic and expected delay in settlement of circular debt balances in the energy sector of Pakistan (as per enquirer an amount ultimately due from the Government of Pakistan) results in an objective evidence of impairment under IAS 39.

The fact pattern is summarized below:

a) The Securities & Exchange Commission of Pakistan (SECP), vide S.R.O 985(I)/2019 (dated September 2, 2019), granted temporary exemption from application of 'Expected Credit Loss (ECL) Method' of IFRS 9, Financial Instruments, to companies holding financial assets due directly or ultimately from the GoP. SECP granted this exemption till June 30, 2021. However, companies availing such exemption were required to follow relevant requirements of IAS 39. (Please note that SECP, subsequently, has extended above-noted exemption till June 2022).

b) Historically, there have been delays in timing of settlement of circular debts. The abovementioned temporary exemption was granted by SECP in the wake of prevailing circular debt issue in the country and considering the uncertainties/practical limitations in determining the timing of settlement of the circular debt.

c) Under IAS 39, companies are required to make an assessment on whether there is any objective evidence of impairment. In the context of circular debt, it has been a country wide consensus that historic and expected delay because of circular debt in the energy sector of Pakistan are not an objective evidence of impairment.

In the context of the above fact pattern, enquirer requested for Board's guidance that whether the historic and expected delay in settlement of circular debt balances in the energy sector of Pakistan results in an objective evidence of impairment under IAS 39.

### The Accounting Standards Board comments and conclusion

1. The Board noted that in Pakistan IFRS 9 has been adopted under the Companies Act, 2017 and it is applicable to companies. The Board also noted that SECP, however, has deferred the applicability of IFRS 9 ECL (i.e. impairment) requirements till June 30, 2022 on the 'financial assets due from the Government of Pakistan'. While granting this relaxation SECP has directed the companies to apply relevant requirements of IAS 39.

   In view of above, impairment related requirements of IAS 39 are applicable on companies that have availed exemption from IFRS 9 ECL requirements.

2. The Board noted that IAS 39 in paragraphs 58 to 65 and AG84-AG93 sets-out the requirements and principle-based guidance for impairment of financial assets.
   In accordance with IAS 39, the assessment of impairment loss on a trade debts/receivable (i.e. circular debt related balances) will include:

   a) assessment of an 'objective evidence' of impairment (the objective evidence is provided by one or more events that occurred after the initial recognition of the trade receivable (a loss event). The loss event (or events) impacts the estimated future cash flows of a trade receivable or a group of such receivables (where loss event(s) does not adversely impact the estimated future cash flows under the contractual terms there would be no impairment); and

   b) a reliable estimation of the above impact.

Where above conditions are fulfilled, impairment loss shall be recognised on a trade receivable.

***Objective evidence of impairment***

3. The Board observed that under paragraph 58 of IAS 39, impairment testing of a trade receivable requires assessment of whether there is any objective evidence of impairment. This assessment shall be based on all available information at the reporting date.

   Objective evidence of impairment could be explained as one or more events that have occurred and have an impact on the expected future cash flows of the financial instruments.

   Paragraph 58 of IAS 39 is reproduced below (emphasis is ours):

   > *<u>"An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63</u> (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) <u>to determine the amount of any impairment loss."</u>*

4. IFRS 9 in paragraph BCE.107, while commenting on impairment model of IAS 39, notes that "the impairment models in IAS 39 require the recognition of credit losses only once there is objective evidence of impairment or when a credit loss is incurred (thus the impairment model includes a 'recognition threshold'). As a result, the effect of future events, even when expected, cannot be considered. This recognition threshold is perceived to have caused a delay in the recognition of credit losses and was identified during the global financial crisis as a weakness in accounting standards."

5. The Board noted that IAS 39 in paragraph 59 lists down examples of loss events that could result in such objective evidence (general triggers).

   In accordance with paragraph 59, objective evidence that a financial asset is impaired includes observable data that comes to the attention of the holder of the asset about the loss events.

   Paragraph 59 is reproduced below (emphasis is ours):

   > *<u>"A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.</u> It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. <u>Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:"</u>*

   *(b) significant financial difficulty of the issuer or obligor;*

   *(c) a breach of contract, such as a default or delinquency in interest or principal payments;*

*(d) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;*

*(e) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;*

*(f) the disappearance of an active market for that financial asset because of financial difficulties; or*

*(g) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:*

*i. adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or*

*ii. national or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).*

6. The Board also noted that IFRS 9 mentions 'credit-impaired' financial assets. In ECL model, a credit-impaired financial asset is at Stage 3, effectively at the point at which there has been an incurred loss event under the IAS 39 model.

The examples in IFRS 9 of when an asset is credit-impaired are identical to the examples that IAS 39 uses to indicate that an impairment loss should be recognized because objective evidence of impairment exists.

Credit-impaired financial asset is defined in IFRS 9, as under:
*"A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:*

*(a) significant financial difficulty of the issuer or the borrower;*

*(b) a breach of contract, such as a default or past due event;*

*(c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;*

*(d) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;*

*(e) the disappearance of an active market for that financial asset because of financial difficulties; or*

*(f) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses. It may not be possible to identify a single discrete event—instead, the combined effect of several events may have caused financial assets to become credit-impaired."*

***Measurement of impairment loss***

7. The Board observed that when the loss event has an impact on the estimated future cash flows of a trade debt, then entity shall consider this impact on the measurement of the impairment loss.

   Under IAS 39 paragraph 63, impairment of trade receivables is measured on the basis of the present value of estimated future cash flows (including the cash flows expected from a collateral and guarantee, under the contractual terms).

   Paragraph 63 of IAS 39 is reproduced below (emphasis is ours):

   *"<u>If there is objective evidence that an impairment loss on loans and receivables or heldto-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows</u> (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss."*

8. The Board noted that an entity has incurred an impairment loss if it is probable that it will not be able to collect all amounts due according to the contractual terms. Contractual cash flows and historical loss experience provide the basis for estimating future cash flows. Based on the principle outlined in IAS 39, in case of delayed settlement of a trade debt:

   (a) there would be no impairment, where, an entity under the contractual terms will receive compensation for every delayed payment (including interest on the delayed payment of principal and liquidated damages/surcharge). In such cases, the present value of future cash flows (both principal and interest) discounted at the receivable's original effective interest rate will equal or more than the carrying amount of the loan/receivable.

   (b) there would be an impairment loss, when, an entity under the contractual terms is not compensated for a delayed payment. In such cases, the present value of future cash flows discounted at the receivable's original effective interest rate will be less than the carrying amount of the loan/receivable

   These scenarios could arise when there is no interest for delayed receipt of principal, or any interest on delayed principal is lower than the market interest-rate, or there is no interest on the delayed payment of original interest.

## Conclusion

9. The Board, based on the enquired fact pattern and above discussion, concluded that:

   a) It is management responsibility and decision to recognise (or not recognise) impairment in the financial statements. The assessment of whether an objective evidence of impairment on a financial asset exists, is a matter of management judgement requiring consideration of all the facts and circumstances of each case.

   b) In accordance with the principle-based approach outlined in paragraph 59 of IAS 39, an objective evidence of impairment exists, when:

      i. one or more events have occurred after the initial recognition of the asset (a 'loss event'); and

ii. that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

c) Paragraph 59 of IAS 39 also states that objective evidence that a financial asset is impaired includes observable data that comes to the attention of the holder of the asset about the loss events.

Paragraph 59 also lists down examples of loss events that could result in objective evidence of impairment.

d) IAS 39 provides sufficient guidance for an entity to assess whether there is an objective evidence of impairment with regards to long overdue circular debt balances, which as per management assessment are directly or indirectly due from GoP.

Management of an entity should exercise its judgement considering all the relevant facts and circumstances to determine whether the delay in the settlement of circular debt balances provides (or does not provide) an objective evidence of impairment under IAS 39.

*(October, 2021)*

## 2. Provisioning requirements for NBFCs under IFRS 9 and the NBFC Regulations 2008

### Brief facts of the enquiry

The Accounting Standards Board (the Board/ASB) received an enquiry about the application of provisioning requirements for Non-Banking Finance Companies (NBFCs) under IFRS 9, Financial Instruments (IFRS 9) and Non-Banking Finance Companies and Notified Entities Regulations, 2008 (the NBFC Regulations).

The fact pattern is summarized below:

(a) In the NBFC Regulations, regulation 25 states that a lending NBFC shall observe the criteria for classification of its assets and provisioning as provided in Schedule X. NBFC Regulations also state that “provided that after adoption and implementation of IFRS 9, the requirements of IFRS 9 shall be applicable.”

(b) ASB, issued the *Accounting Guidance – Application of IFRS 9 by Non-Banking Finance Companies* (IFRS 9 Application Guidance), in May 2021. Annexure 1 of this Guidance:

- describes the mechanism to be applied for mapping of time-based criteria. It is based on the time-based criteria outlined in the NBFC Regulations and the Expected Credit Loss (ECL) staging requirements set out in IFRS 9.

- outlines that provision for impairment shall be higher of IFRS 9 ECL model and the NBFC Regulations.

(c) On the above guidance and requirements of Annexure 1 of IFRS 9 Application Guidance, enquirer had sought clarifications from the Securities and Exchange Commission of Pakistan (SECP). SECP had advised the enquirer to follow the IFRS 9 Application Guidance for calculation of provision (i.e. higher of IFRS 9 ECL and the NBFC Regulations).

(d) Regarding the practical implementation of IFRS 9 Application Guidance, SECP advised the enquirer to obtain clarification from the ASB. The enquirer had accordingly requested for Board’s opinion on whether the calculation of higher provisioning (between IFRS 9 or the NBFC Regulations) would be assessed by an NBFC on the overall portfolio level or it would be assessed on the level of individual borrower.

### The Accounting Standards Board comments and conclusion

1. The Board noted that the SECP, through S.R.O. 800 (1)/ 2021 (dated June 22, 2021) has further deferred the application of IFRS 9, for Non-Banking Finance Companies (NBFCs). For NBFCs, SECP has made IFRS 9 applicable from June 30, 2022 (with earlier application permitted).

### IFRS 9 ECL Model

2. The Board noted that IFRS 9 impairment model is based on changes in ECL and involves a three stage approach.

   - **Stage 1** includes financial instruments that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date.

   - **Stage 2** includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of impairment.

- **Stage 3** includes financial assets that are credit impaired, having objective evidence of impairment at the reporting date.

**Provisioning requirements of the NBFC Regulations**

3. The Board observed that the NBFC Regulations specify the requirements for NBFCs to maintain ‘Specific’ and ‘General’ provisions for their financial assets.

   - Regulation 25 of the NBFC Regulations, prescribes specific provisioning requirements for nonperforming assets. Regulation 25 requires that a lending NBFC shall observe the criteria for classification of its assets and provisioning as provided in Schedule X.

     Schedule X of the NBFC Regulations, outlines a time based criteria for classification and provisioning of loan/lease assets (separately for microfinance portfolio and all financing facilities other than micro-finance).

   - Regulation 25A of the NBFC Regulations, prescribes the requirement to maintain General provision.

     Under regulation 25A, an NBFC with micro-finance portfolio and unsecured finance portfolio shall maintain a general provision equivalent to 0.5 per cent of the net outstanding micro-finance portfolio and 1 per cent of the net outstanding unsecured finance portfolio.

**Accounting Guidance ‘Application of IFRS 9 by Non-Banking Finance Companies’**

4. The Board with the objective to facilitate NBFCs in the implementation and transition to IFRS 9, issued an Accounting Guidance titled ‘Application of IFRS 9 by Non-Banking Finance Companies’ (IFRS 9 Application Guidance).

5. It is relevant to mention that the Board, for the development of this accounting guidance, formed a Working Group which included representation of SECP. Further, IFRS 9 Application Guidance was issued in consultation and concurrence with SECP.

6. IFRS 9 Application Guidance (in Annexure I) outlines the principle that after adoption of IFRS 9 the provision for impairment shall be at the amount that is higher of IFRS 9 ECL and the NBFC Regulations. Annexure I outlines the calculation mechanism as under:

   (a) IFRS 9 stage 1 and stage 2 ECL should be compared with provision calculated as per regulation 25 A of the NBFC Regulations; and

   (b) IFRS 9 stage 3 ECL should be compared with provision calculated as per regulation 25 of the NBFC Regulations.

7. The Board noted that in IFRS 9, stage 3 ECL is linked with the ‘default’ of the borrower. In general, this stage reflects the increase in credit risk to a stage where a loan is considered as credit-impaired.

   While, under the NBFC Regulations, default is a time-based criteria and such loans/portfolio is considered as non-performing.

   IFRS 9 stage 3 portfolio would be credit-impaired and in principle it would be similar to the nonperforming portfolio of NBFC Regulations.

8. The Board considered that it is important to highlight the rationale for the approach of maintaining a provision that is higher of IFRS 9 and the NBFC Regulations.

The Board also noted that various regulators have outlined an approach of maintaining a provision that is higher of the IFRS 9 ECL and local prudential regulations.

The Board observed that the regulatory approach of maintaining the provision under IFRS 9 and the NBFC Regulations is to avoid under-provisioning of classified financial assets, after implementation of IFRS 9.

It is expected that provisioning as per IFRS 9 requirements would generally be higher than provision calculated under the NBFC Regulations. However, in initial years of IFRS 9 implementation, from a supervisory and regulatory perspective, an inefficient ECL model could lead to under-provisioning for impairment.

9. The Board observed that as the objective of above-noted approach is to ensure the recognition of provision under the NBFC Regulations as a bare minimum, therefore, the comparison between IFRS 9 ECL and the NBFC Regulations is to be done at portfolio level rather than individual borrower level. Portfolio-based analysis would ensure that the total provision recognised by the NBFCs will not be less than provision required under the NBFC Regulations.

**IFRS 9 application approach adopted by local and international banking sector regulators**

10. In context of the enquired matter, a limited desk research about the IFRS 9 application and implementation guidance issued by following local and international regulators also provided relevant information.

- State Bank of Pakistan
- Central Bank of United Arab Emirates

**Approach followed by the State Bank of Pakistan**

11. The Board noted that State Bank of Pakistan (SBP) has issued IFRS 9 Financial Instruments Application Instruction for banks.

The Board noted that SBP requires the financial institutions to concurrently compute the total provisions for impairment as required by existing instructions (i.e. Prudential Regulations) and IFRS 9 guidelines on performing, underperforming and non-performing credit exposures.

Further, the provision to be accounted for by the banks should be higher of IFRS 9 ECL or Prudential Regulations requirements.

12. The Board also noted that, SBP under the IFRS 9 Application Instructions (Annexure-I) has also outlined an approach for comparison of provision as higher of IFRS 9 ECL and the Prudential Regulations. This approach is similar to one set out by the Board in the IFRS 9 Application Guidance for NBFCs. SBP in Annexure–I of the IFRS 9 Application Instructions, outlined that:

- IFRS 9 stage 3 ECL would be compared with the total amount of specific provision calculated as per the Prudential Regulations; and
- Aggregate of IFRS 9 stage 2 and stage 1 ECL would be compared with the total amount of general provision calculated as per the Prudential Regulations.

**Approach followed by the Central Bank of United Arab Emirates**

13. The Board also noted that Central Bank of United Arab Emirates has also issued Guidance Note on IFRS 9 application. The Guidance note mentions that:

*"In the initial years of IFRS 9 implementation, the existing CBUAE regulation on provisioning will be maintained in parallel. Banks and FIs should recognise any shortfall in IFRS 9 impairments when compared to the CB UAE provisioning regulation.*

*If the general or specific provision as per the CB UAE regulation is higher than the impairment allowance computed under IFRS 9, the difference should be transferred to an Impairment Reserve from retained earnings. The Impairment Reserve should be split to the difference in general provisions and to the difference in specific provisions."*

14. The Board also noted that Central Bank of UAE has adopted IFRS 9, however, it also requires provisions as per the local Regulations. This provision should be maintained in parallel with IFRS 9 ECL based provision.

    Further, a desk study of audited financial statements of a Central Bank of UAE's financial statements showed that for financial reporting purposes the practical application and calculation is based on below:

    - IFRS 9 stage 3 ECL is compared with the total amount of specific provision; and
    - Aggregate of IFRS 9 stage 2 and stage 1 ECL is compared with the total amount of general provision (calculated as per local provisioning regulations / requirements).

## Conclusion

15. The Board, based on the understanding of enquirer's submission and above detailed discussion and analysis, concluded that:

    (a) NBFCs shall recognise impairment at an amount that is higher of IFRS 9 Expected Credit Loss (ECL) and the NBFC Regulations. An NBFC would be recognizing any shortfall in IFRS 9 impairment when compared to the provisioning requirements of the NBFC Regulations. In this way, total provision for impairment, consequent to the adoption of IFRS 9 by an NBFC, would not be less than provision that was being recognised as per the NBFC Regulations.

    (b) The NBFC Regulations, under regulations 25 and 25 A, require 'specific' and 'general' provisions. The specific provision (on a time-based criteria) is required for the 'nonperforming' financial assets, while general provision is for the 'performing' financial assets.

    IFRS 9 ECL outlines a 'three-stage' model for impairment. This three-stage model is based on changes in credit quality of a financial asset, since its initial recognition. Stage 3 is considered as 'non-performing' (i.e. credit impaired) category of financial assets, while stage 1 and stage 2 are considered as performing and underperforming financial assets.

    (c) The IFRS 9 ECL impairment should be compared with the provision calculated under the NBFC Regulations, at the portfolio level (rather than at individual borrower level).

    For this purposes, the portfolio should be based on the level of aggregation, principally outlined in the NBFC Regulations. Based on this portfolio approach:

    i. IFRS 9 stage 3 ECL should be compared with the specific provision calculated as per regulation 25 of the NBFC Regulations; and

ii. Aggregate of IFRS 9 stage 1 and stage 2 ECL should be compared with the general provision calculated as per regulation 25A of the NBFC Regulations.

It is relevant to mention that the NBFC Regulations specify different requirements of general and specific provisioning for ‘micro-finance’ and ‘other than micro-finance facilities’, the aggregation and comparison (between IFRS 9 ECL and provisioning as per the NBFC Regulations) based on above approach, therefore, should be done separately for micro-finance and other than micro-finance facilities.

*(October, 2021)*

## 3. Enquiry on the impact of subsequent recovery of a loan on the provision for impairment at the reporting date

### Brief facts of the enquiry

The Accounting Standards Board (the Board) has received an enquiry regarding the impact of subsequent recovery of a loan on the provision for impairment at the reporting date.

In the fact pattern described in the enquiry:

- An entity, after its reporting date of December 31, 2020, receives cash from a customer. This cash represents recovery of an outstanding loan balance. The loan settlement agreement with the customer was executed on the reporting date. However, the proceeds from customer were credited to the entity's bank account after the reporting date as the cheque through which the proceeds were transferred was also dated after the reporting date.

- With this basic information, guidance has been sought on the impact of subsequent recovery of loan on the provision for impairment at the reporting date, under the three (03) scenarios relating to listed company, listed modaraba and a non-going concern modaraba.

**Scenario A - Measurement of provision for impairment by a listed company under IFRS 9**

Under this scenario, the reporting entity is a listed public company.

Company has calculated and recognized a provision (based on provision matrix) for impairment against the receivable balance from a customer, in accordance with IFRS 9, Financial Instruments. However, as noted in the basic information, subsequent to the reporting date and before the issuance of financial statements, company recovers the amount from the customer. In such a scenario, following questions have been asked in the submission:

- whether the recovery from the customer after the reporting date be considered as an adjusting event for the financial statements for year ended December 2020; and

- whether the provision (in context of the subsequent recovery) should be reversed in December 31, 2020 financial statements.

**Scenario B - Measurement of provision for impairment by a modaraba, under the accounting and reporting standards as applicable in Pakistan**

Under this scenario, the reporting entity is a financial services modaraba listed on Pakistan Stock Exchange.

Modaraba has calculated and recognised a provision for impairment against the receivable balance from a customer, based on provision matrix prescribed in the Modaraba Regulations. However, subsequent to the reporting date and before the issuance of financial statements, modaraba recovers the amount from the customer. In such a scenario, following questions have been asked in the submission:

- whether the recovery from the customer after the reporting date be considered as an adjusting event for the financial statements for year ended December 2020; and

- whether the provision (in context of the subsequent recovery) should be reversed in December 31, 2020 financial statements.

**Scenario C - Measurement of provision for impairment by a non-going concern modaraba, under the accounting and reporting standards as applicable In Pakistan**

Under this scenario, the reporting entity is a modaraba listed on Pakistan Stock Exchange and the financial statements for December 31, 2020 have been prepared on a basis other than going concern. In those financial statements, assets and liabilities are reported on the basis of their respective net realizable values.

Based on provision matrix prescribed in Prudential Regulations, modaraba has calculated and recognised a provision for impairment against the receivable balance from a customer.

In such a scenario it has been asked in the submission, whether the subsequent recovery will be reflected in calculating the net realizable value of receivables at the reporting date, despite the fact that recovery was made in subsequent period?

## The Accounting Standards Board comments and conclusion

**Scenario A**

1. In the context of the submitted fact pattern, the Board noted that a public listed company is required to recognize an impairment allowance for receivable balance(s) in accordance with the expected credit loss (ECL) model of IFRS 9, Financial Instruments.

   IFRS 9 requires measurement of expected credit losses in a way that reflects reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

2. The Board noted that IAS 10, Events after the Reporting Period, requires an entity to adjust the amounts recognized in its financial statements to reflect adjusting events after the reporting period.

3. The Board noted that IFRS 9 does not specifically require that new information that becomes available after the reporting date has to be reflected in the measurement of ECL at the reporting date. However, the Transition Resource Group for Impairment of Financial Assets (formed by International Accounting Standards Board with the aim of providing support for the implementation of the new expected credit loss requirements in IFRS 9) has discussed this matter in 2015.

4. The Board, based on the principles set out in IAS 10 regarding adjusting and nonadjusting events and discussions of Transition Resource Group for Impairment of Financial Assets, concluded that a listed company should apply judgement as per the specific facts and circumstances to determine whether a subsequent recovery of a receivable (I.e. cash recovery between the reporting date and the date the financial statements are authorized for issue) is an 'adjusting' or 'non-adjusting' event in accordance with IAS 10.

In case, a loan-specific information and related facts that existed at the reporting date is an 'adjusting event' in accordance with IAS 10, a listed company while applying IFRS 9 should update its estimation of credit losses as of the reporting date with the information about such adjusting event. In this regard, materiality considerations outlined with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, would also be relevant.

**Scenario B**

5. With regards to the fact pattern submitted by enquirer under scenario B, the Board noted that a modaraba is required to prepare its financial statements in accordance with the ACCOUNTING ICAP SELECTED OPINIONS - VOLUME XXVII The Institute of Chartered Accountants of Pakistan Page 12 of 59 accounting and reporting standards as

applicable in Pakistan. This financial reporting framework applicable to modaraba includes International Financial Reporting Standards (IFRS Standards) issued by the International Accounting Standards Boards (IASB) as notified under the Companies Act, 2017 and the requirements of the Companies Act, Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980, Modaraba Companies and Modaraba Rules, 1981 and Modaraba Regulations, 2021 (Modaraba Regulations). Further, wherever provisions of and directives issued under the above-mentioned statute differ from IFRS Standards, the provision of and directives issued under the statutory instrument should prevail.

6. The Board further noted that a modaraba is required to comply with the requirements of Modaraba Regulations, for the classification and provisioning for non-performing assets. In this regard, regulation 14 of the Modaraba Regulations, together with Schedule III thereof, specify a time-based classification and provisioning criteria. While, regulation 15 discusses the reversal of provisioning where there is cash recovery.

7. The Board also noted that IAS 10, Events after the Reporting Period, being part of IFRS Standards is also applicable to a modaraba. IAS 10 requires adjustment of the amounts recognized in its financial statements to reflect adjusting events after the reporting period.

8. The Board concluded that a modaraba should consider the requirements of IAS 10 while calculating and recognizing the provision for non-performing assets at the reporting date. A subsequent recovery against a loan could be an adjusting event based on the loanspecific facts and circumstances. A modaraba should update its provisioning as of the reporting date, consequent to the subsequent recovery, if such recovery is an adjusting event in accordance with IAS 10. In this regard, materiality considerations outlined with IAS 8 would also be relevant.

**Scenario C**

9. In context of the fact pattern submitted in scenario C, the Board noted that the statutory financial reporting framework (as noted in paragraph 5, above) does not change for a modaraba that is a non-going concern entity. In context of the submitted scenario, while preparing statutory financial statements, the requirements of Modaraba Regulations and IAS 10 would be part of the financial reporting framework applicable to a non-going concern modaraba.

10. The Board concluded that based on the conclusions outlined in scenario B, above, a modaraba should consider the requirements of IAS 10 in relation to treatment of subsequent recovery against a loan and determination of carrying value of such loan at the reporting date.

*(September 2021)*

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

**Brief facts of the enquiry:**

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

**Opinion:**

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

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

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

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

> *"An entity shall change an accounting policy only if the change:*
>
> *(a) is required by an IFRS; or*
>
> *(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows."*

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

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

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

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

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

a) A change in accounting policy by an NBFC (after applying IFRS 9 in the year 2019) to avail regulatory deferment from IFRS 9, does not seem to meet the criteria for change in accounting policy as outlined in IAS 8.

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

*(Issued in November 2020)*

## 5. Accrual of mark-up on a defaulted loan under IFRS 9 Financial Instruments – Recognition & Measurement

**Enquiry:**

We are seeking your advice on the matter of continuation of accrual of Markup on a loan we obtained almost a decade ago. We are referring to you our one such case below as an example.

We obtained a loan of Rs. 100 million from a scheduled bank of Pakistan on March 17, 2005. On our inability to repay the loan, we got the repayment schedule restructured, but we defaulted repayment of last instalment of Rs. 12.5 million (Principal portion), due on March 17, 2009. We have been continuously accruing Markup on the Principal Amount on the basis of 6 month KIBOR + 1.5% as agreed in the revised terms of contract.

Our directors are of the view that because the tenure of the repayment has elapsed, therefore, we should not accrue markup anymore and reverse such accounted for liability. Please communicate us your professional advice regarding accrual of Markup.

**Opinion:**

The Board noted that paragraph 11 of IAS 32 Financial Instruments: Presentation defines a financial liability as (relevant portion reproduced only and underline added):

> *"A financial liability is any liability that is:*
>
> *(a) a contractual obligation:*
>
> *(i) to deliver cash or another financial asset to another entity; or*
>
> *(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity;"*

Paragraph 13 of IAS 32 explains that 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts and thus financial instruments, may take a variety of forms and need not be in writing.

Further, paragraph 35 of IAS 32 requires that interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.

The Board understands that the finance obtained from the National Bank of Pakistan (NBP) was being classified and measured as a financial liability subsequently measured at amortised cost in accordance with the requirements of IAS 39/IFRS 9 Financial Instruments: Recognition & Measurement.

The Board noted that, generally, when the companies contemplate that they might not be able to settle its liability in compliance with the repayment terms as agreed in the contract, they approach the lender for restructuring of loan on revised terms. A restructuring of loan modifies the amounts and timings of the contractual cash flows and consequently, the borrower either restates the same financial liability or derecognizes the original financial liability and recognizes a new one depending on whether there has been a substantial modification in the terms of original financial liability. Paragraph 3.3.2 and 3.3.3 of IFRS 9 state:

> *"3.3.2 An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.*

> *Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability."*
>
> *"3.3.3 The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss."*

As submitted by the enquirer, the Board noted that the company had previously restructured the finance obtained from the NBP and has defaulted on last installment of restructured financial liability. Further, the Board understands that the company has not been able to further restructure the finance obtained from the NBP and consequently, the entire outstanding balance of the finance facility is currently payable by the company.

The Board finds it important to highlight that, post default, the amount at which the liability should be measured in the financial statements should equal the amount required to settle the liability at the reporting date. This would in turn, depend on the terms and conditions outlined in the original contract of the finance facility pertaining to additional charges and penalties in the event of default, legal requirements and the outcomes of current negotiations with the lender on settlement. Therefore, the Board noted that the management needs to work out its best estimate of the amount required to settle the outstanding liability at the reporting date in accordance with the requirements of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Further, the Board would like to highlight that, in the submitted fact pattern, consideration of the legal implications arising from the default of loan facility is also important. The legal recourse available to the financial institutions in the event of default by a customer is provided in the Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997 (the Act).

Section 9(1) of the Act states where a customer or a financial institution commits default in fulfillment of any obligation with regard to any finance, the financial institution or, as the case may be, the customer may institute a suit in the Banking Court by presenting a plaint which shall be verified on oath, in the case of a financial institution by the Branch Manager or such other officer of the financial institution as may be duly authorized in this behalf.

Section 3 of the Act outlines obligations of a defaulting customer to a financial institution as follows (underline is ours):

> *"(1) It shall be the duty of a customer to fulfil his obligations to the financial institution.*
>
> *(2) Where the customer defaults in the discharge of his obligation<u>, he shall be liable to pay, for the period from the date of his default till realization of the cost of funds of the financial institution as certified by the State Bank of Pakistan from time to time, apart from such other civil and criminal liabilities that he may incur under the contract or rules or any other law for the time being in force.</u>*
>
> *(3) For purposes of this section a judgment against a customer under this Ordinance shall mean that he is in default of his duty under sub-section (1), and the ensuing decree shall provide for payment of the cost of funds as determined under sub-section (2)."*

Accordingly, the Board understands that in ascertaining the amount at which the loan facility should be measured at the reporting date, the management should take into account all the pertinent facts and circumstances including any liability to pay cost of funds arising as a result of legal action taken by the lender.

Further, with regard to reversal of interest already accrued post default, the Board noted that the relevant guidance is provided in paragraph 3.3.1 of IFRS 9 as reproduced below (underline is ours):

> *"An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—i.e. when the obligation specified in the contract is discharged or cancelled or expires.*

The Board understands from the above requirement that the permissibility of reversing the interest already accrued post default depends on whether the obligation to pay interest for periods after default exists or not. As discussed above, this determination would depend on the terms and conditions outlined in the original contract of finance facility pertaining to additional charges and penalties in the event of default, legal requirements and the outcomes of current negotiations with the lender on settlement.

*(October 9, 2019)*

## 6. Guidance on reclassification of investments out of fair value through profit or loss category under IAS 39 Financial Instruments: Recognition and Measurement

**Enquiry:**

This is to seek the professional advice from the Department in relation to reclassification of the investments carried at fair value through P&L category to Available for Sale category incase no trading has been carried from financial year 2014 till to date. We understand that IAS 39 allow such treatment in rare circumstances as described below but does not categorically define such circumstances

Paragraph 50B of IAS 39 (of 2009 edition) states:

> *"A financial asset to which Paragraph 50(c) applies (except a financial asset of the type described in paragraph 50D) may be reclassified out of the fair value through profit and loss category only in rare circumstances".*

This is to enquire whether the reclassification out of the fair value through fair value through P&L category would be permissible under IAS 39 of 2009 edition in the circumstances as defined above.

**Opinion:**

With regard to the enquiry the Board notes that guidance should be obtained from IAS 39 Financial Instruments: Recognition and Measurement.

IAS 39 classifies financial assets measured at 'fair value through profit or loss' (FVTPL) in to two sub-categories, i.e. those classified as held for trading and those designated upon initial recognition as at fair value through profit or loss.

In accordance with paragraph 9 of IAS 39, a financial asset is classified as held for trading if:

i) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

ii) on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

iii) it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Further, in accordance with paragraph 9 of IAS 39, a financial asset may be designated upon initial recognition as FVTPL only in the following two circumstances;

i) if a contract contains one or more embedded derivatives subject to fulfillment of conditions contained in paragraph 11A of IAS 39;

ii) the designation of financial asset at fair value through profit or loss results in more relevant information because it either eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases, or a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy and information about the group is provided internally on that basis to the entity's key management personnel.

In accordance with paragraph 50 of IAS 39, the permissibility of reclassification of a financial asset out of FVTPL to another category depends on whether the financial asset is held for trading or it is designated upon initial recognition as at fair value through profit or loss.

Paragraph 50 read with 50B of IAS 39 permits reclassification out of held from trading category, but only in "rare circumstances". Further, paragraph 50 of IAS 39 does not permit reclassification of a financial asset designated upon initial recognition as at fair value through profit or loss, or a financial asset held for trading which is a derivative, out of the FVTPL category. IAS 39 does not specify the "rare circumstances" in which the reclassification out of FVTPL category is permissible. However, a discussion regarding "rare circumstances" is noted in Basis of conclusion of IAS 39, related paragraph is BC104D as under (relevant portion is reproduced):

> *"The Board therefore decided to permit non-derivative financial assets to be reclassified out of the held-for-trading category in the same circumstances as are permitted in SFAS 115 and SFAS 65. The Board also noted that rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term…."*

Therefore, the Board understands that rare circumstances are such circumstances that arise from a single unusual event which is highly unlikely to recur in the near term. The Board further understands that the reclassification amendments to IAS 39 were issued by the International Accounting Standards Board (IASB) in October 2008 in response to the global credit crisis. In this regard, the Board would like to refer the IASB press release that accompanied the issue of amendments to IAS 39, issued on October 13, 2008.

IASB press release stated that:

> *"The deterioration of the world's financial markets that has occurred during the third quarter of this year is a possible example of rare circumstances cited in these IFRS amendments and therefore justifies its immediate publication".*

Based on the above, the Board notes that in the enquired scenario the reclassifications must be justified under the rare circumstances (in accordance with IAS 39, paragraph. 50B), which was according to the IASB the case under the market condition of 2008. The nature, significance and frequency of the events/ circumstance/s shall be such that make it rare circumstances, under IAS 39. Accordingly, an entity seeking to claim rare circumstances will need to demonstrate that the turmoil in the world's financial markets has directly affected its intentions in relation to the investments it has held.

Further, the Board notes that IAS 39 in describing the held for trading category, uses the wordings "principally for the purpose of selling or repurchasing it in the near term". The decision to classify an investment in shares of listed company for trading occurs at its acquisition. The classification is not precluded simply because the company does not intend to sell the held shares in near term.

Therefore, based on the above discussion, the Board is of the view that when a company seeks to reclassify the investments out of held for trading category it is required to demonstrate that the turmoil in the country's financial markets has directly affected its intentions in relation to the investments it has held. The mere non-trading of the equity investments that are principally held for trading does not fall under the rare circumstances cited in IAS 39.

*(July 24, 2018)*

## 7. 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)*

## 8. Accounting treatment of accrued Markup Liability

**Enquiry:**

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

Your suggestion is required in respect of following:

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

If above is not suggested:

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

**Opinion:**

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

> 40 An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.
>
> AG62 For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

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

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

(*November 10, 2015*)

## 9. Amortization of Director's Loan

### Enquiry:

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

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

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

1. Company is not able to repay the loan

2. Client income will be liable to income tax.
3. Disclosure of repayment as per ISA 39 Para 9 will have significant impact on Financial Statement.

Please advise on the following:

1. What steps should we take if the client refuses to amortize the directors/sponsors loan?

2. What time period does amortization of the directors loan needs to be carried out?

3. Please guide how the amount should be disclosed in the accounts when the loan relates to more than 10 years and payable when able. In actual fact it is not repayable by the company.

4. Under the Companies Ordinance, 1984 company can't hold share application money for indefinite period.

### Opinion:

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

> *11 A **financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.*
>
> *A **financial liability** is any liability that is:*
>
> *(a) a contractual obligation*
>
> *(i) to deliver cash or another financial asset to another entity; or*
> *(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or*
>
> *(b) a contract that will or may be settled in the entity's own equity instruments……..*
>
> *19 If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability, except for those instruments*

*classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D.*

*For example:*

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

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

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

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

1. Financial liabilities at fair value through profit or loss

2. Other financial liabilities measured at amortised cost using the effective interest method.

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

AG64 and AG65 of IAS 39 give recognition of interest free long-term loan. Interest free loans are commonly made between entities in a group or a loan given by directors to company on a non-arm's length terms and/ or made with no stated date for repayment. In this case, the required accounting depends on the terms, conditions and circumstances of the loan. It is therefore necessary to ascertain the terms and conditions, which may not be immediately apparent if the loan documentation is not comprehensive. It is pertinent to note that IAS 32 also does not put a condition that contractual obligation must be evidenced by a written or registered contract.

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

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

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

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

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

1. The auditor's opinion whether or not to qualify audit report will be based upon the evidence obtained during the audit. The Committee is of the view that if the client refuses to amortize the director's loan then the auditor will have to analyze the evidences obtained and should form an appropriate opinion considering the compliance of respective IFRSs and the requirements of ISAs.

2. It depends on repayment terms and conditions of loan. If there is no repayment term then loan should be classified as short term.

3. When the loan relates to more than 10 years and it is certain that company will be unable to pay it or repayment is indeterminable then it would be classified as a liability.

4. For share deposit money, the Committee would like to refer its Selected Opinion No. 1.4 of 'Volume XVI on 'clarification on share deposit money' which addresses your issue.

*(August 21, 2015)*

## 10. Application of IAS 39 to directors' interest free loans

**Enquiry:**

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

> "**2.3.1 Application of IAS 39 'Financial Instruments: Recognition and Measurement**
>
> Deficiencies in initial recognition and subsequent measurement of interest free long term loans and liabilities were noted in number of audit engagements reviewed during the period.
>
> It was observed that interest free long term loans and liabilities, most of them from related parties, were recognized initially at the loan amount received as against the fair value of the loan amount and were not subsequently carried at their amortized cost using effective interest method. Most of the audit engagement partners were of the opinion that these are interest free loans with no agreed repayment terms or defined maturity; therefore it was difficult for management to estimate future cash flows and calculate effective interest rate of the loan.
>
> The QAB would like to draw attention to requirements of IAS 1 "Presentation of Financial Statements" which requires that the liabilities can be classified as non-current only in specific circumstances. One of the requirements is for the entity to have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Accordingly, all liabilities with no agreed repayment terms or defined maturity are to be considered as due on demand and should be classified as current.
>
> Whereas in respect of loans and liabilities where the entity has agreed with the lenders not to demand repayment for a particular period (in excess of twelve months after the reporting period) should be discounted over the agreed period."

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

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

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

> "A '**financial instrument'** is any **contract** that gives rise to a **financial asset** of one entity and **financial liability** or equity instrument of another entity.
>
> A '**financial liability'** is any liability that is:
>
> (a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes true entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipts or delivery of the entity's own equity instruments."

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

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

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

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

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

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

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

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

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

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

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

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

**Opinion:**

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

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

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

(a) a contractual obligation:

(iii) to deliver cash or another financial asset to another entity; or

(iv) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments

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

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

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

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

A financial instrument will be a financial liability, where it contains an obligation to repay. Para 47 of IAS 39 '*Financial Instruments:*

*Recognition and Measurement'* recognises two classes of financial liabilities:

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

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

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

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

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

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

The above is also supported from statutory requirements contained in Sections 196, 214 to 216, and 218 to 219 of the Companies Ordinance, 1984 (the Ordinance) in case loan is borrowed from a director. Discussion of proposed loan/ borrowing in the board's meeting, due deliberations regarding objectives and usability of such loan / borrowing and the resolution passed by the Board to approve such loan / borrowing also establishes the contractual obligations. Though many times, repayment terms and conditions are not defined but at one point or the other these would be defined and it does not change the substance as well the legal form of the transaction.

It is important to note that where no repayment period is defined and loan is dependent on the entity's ability to repay (or payable on demand) it becomes current liability of the borrower.

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

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

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

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

*(July 01, 2015)*

## 11. Amortization of Interest Free Loan under IAS 39

### Enquiry:

1. This is with reference to the subject matter where it has been observed that the companies are following different accounting practices as follows:

   (a) No amortization of the interest free loan;

   (b) Amortization of the interest free loan and accounting for the amortized gain in Profit & Loss Account (P&L); and

   (c) Amortization of the interest free loan and accounting for the amortized gain in Equity.

2. In this connection, it has been noticed that when the amortized gain is credited to P&L, as per the requirements of International Accounting Standard (IAS) 39 "Financial Instruments: Recognition and Measurement", the tax authorities are treating the said income as taxable. This is one of the reasons that the companies are reluctant to follow the treatment of carrying the interest free loan on amortized cost as required under IAS 39.

3. Secondly, it has also been observed that the amortized gain is being accounted for within the equity rather than treated as income in the P&L. In this regard, your valuable opinion is solicited whether the aforesaid treatment is in line with the requirements of the IASs.

4. With regard to Para 2 above, you are requested to take up the matter with the Federal Board of Revenue on the issue of taxability of amortized gain under intimation to us, in order to streamline the accounting treatment and / or taxable issues of the subject matter.

5. Moreover with regard to Para 3 above, you are requested to confirm whether the treatment of accounting the amortized gain in equity is a valid treatment under the IASs.

### Opinion:

The Committee considered your enquiry and its views are as follows:

The fair value of inter-company loans usually need to be estimated and the difference between fair value and loan amount then needs to be accounted for.

Where the loan is from a parent to a subsidiary, it would be inappropriate to recognise a gain or loss for the discount or premium; in substance this is an additional contribution by the parent (or a return of capital/distribution by the subsidiary). Contributions from and distributions to "equity participants" do not meet the basic definition of income or expenses (refer Framework para 70). In this case, the difference between the loan amount and the fair value (discount or premium) should be recorded as:

- an investment in the parent's financial statements (as a component of the overall investment in the subsidiary);
- a component of equity in the subsidiary's financial statements.

Subsequently, the loan should be measured at amortised cost, using the effective interest method. This involves "unwinding" the discount such that, at repayment, the carrying value of the loan equals the amount to be repaid. The unwinding of the discount should be reported as interest income or expense.

Where the loan is between group entities other than a parent and subsidiary, the discount or premium may meet the definition of income or expense depending on whether or not, in substance, the transaction is carried out at the direction of the parent. In this case, the Committee would like to refer its Selected Opinion No. 1.9 *'Measurement of Interest Free (Low Interest Rate Loans Received/ Advanced By Companies'* of Volume XII which addresses your issue.

With regard to take up this issue with the Federal Board of Revenue (FBR), the Committee is of the view that accounting treatment of amortization of interest free loan is clear in IAS 39. If the Commission has identified the taxability issues in certain companies then the Committee suggests interested parties to take up the matter directly with the FBR.

*(February 11, 2015)*

## 12. Technical Opinion on IAS 39

**Enquiry:**

**Issue-I**

Many entities have continued financial support from their directors/ sponsors etc. in form of interest free loans. There are normally no determinable repayment terms.

*IAS-39 requires*

*Borrowings are initially recognized at fair value less attributable transaction cost. Subsequent to initial recognition, these are stated at amortized cost with any difference between cost and redemption value being recognized ' in profit or loss over the period of the borrowings on an effective interest basis."*

As per paragraph 47 of the Standard, all financial liabilities, with exception of certain liabilities specifically excluded by the standard from scope of the paragraph, are required to be measured at amortized cost using the effective interest method

The normal treatment in the audited financial statements is through disclosure in the notes to the accounts with emphasis on the fact that repayment terms are not determinable.

*IAS* 1 *requires.*

15. Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

16. An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs.

17. In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity:

    (a) to select and apply accounting policies in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. IAS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of an IFRS that specifically applies to an item.

    (b) to present information, including accounting policies, in a manner that provides relevant reliable, comparable and understandable information.

    (c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

18 An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

It is clear that IAS-I requires compliance to all IFRSs and IASs.

**Opinion required:**

1 Is it sufficient to give disclosure that the repayment terms for the loans from directors' sponsors etc are not determinable?

2 Is it not a departure from IAS-39 requirements? Accordingly should not the audit report be qualified indicating that the requirements of IAS-39 have not been met with an explanations of the reasons for non -compliance?

3 Should not the departure be identified in the 'Compliance Statement'?

4 Is the repayment tenure considered to be determinable if loans from directors' sponsors etc. are subordinated to loans from banks and financial institutions?

It may be noted in some cases where the audit report has been qualified; SECP has forced the entity to measure loans from directors' sponsors etc. at amortized cost using the effective interest method even in absence of determinable repayment terms.

**Issue-2**

In many entities there are issues pertaining to loans from banks and financial institutions which are in default and/or subjudice. It has been observed that a disclosure to the fact is made in the notes to financial statements with the explanation that classification between current and non-current liabilities is not practicable. Additionally if the matter is subjudice no provisions are made for markup.

**Opinion Required:**

1. Is it sufficient to give disclosure as noted above?
2. Is it not a departure from IAS-I requirements? Accordingly should not the audit report be qualified indicating that the requirements of IAS-I have not been met with an explanation of the reasons for non-compliance?
3. Should not the departure be identified in the 'Compliance Statement'?

**Opinion:**

The Committee considered your queries and response to the questions are as follows:

**ISSUE-1**

1. If the repayment terms of the loans from directors' sponsors are not determinable then the payment of loan would remain on demand by the director' sponsor; and hence should be disclosed as short term loan.

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

2 & 3. It will always be the auditor's prerogative to give an opinion, based upon the evidence obtained whether or not to qualify audit report. The Committee is of the view that the auditor will have to form an appropriate opinion, based on his own judgment, after analyzing the evidences obtained.

4. The Committee is of the view that a director loan subordinated to a bank loan will be payable after the bank loan has been fully extinguished. Therefore, the minimum term of the director's loan can be taken as the term of the bank loan, however, the exact term is indeterminable in the absence of a covenant.

**ISSUE-2**

1 Where the loans from banks or financial institutions are in default or subjudiced, the payment of loan would be considered on demand; and therefore classified as current.

2 It will always be the auditor's prerogative to give an opinion, based upon the evidence obtained whether or not to qualify audit report. The Committee is of the view that the auditor will have to form an appropriate opinion , based on his own judgment, after analyzing the evidences obtained

3 The issue identified in the query does not raise any effect on the 'Compliance Statement'.

*(August 29, 2013)*

## 13. Recognition of interest on Defence Saving Certificate held by an Employee's Provident Fund

### Enquiry:

We would like to draw attention and seek advice of the technical committee of the Institute towards the treatment of held to maturity investments which are to be recorded at amortised costs using the effective interest rate method. Here we are specifically referring to the investment made in Defence Saving Certificates (DSC) which is issued and regulated by National Savings, Ministry of Finance, Pakistan.

**Issue no. 1**

The authority provides a schedule of interest accruing every year along with an effective interest rate. The amount of interest accruing in the year of maturity (10$^{th}$ year) as per the said schedule agrees to the calculations made using the effective interest rate, however, the same mode of calculation gives different results to what is provided in the schedule when calculating the accrued interest for any time between 1$^{st}$ to 9$^{th}$ year subsequent to the certificate is purchased. This leads to drastic variations between the calculation made by applying effective interest method and the amount of interest that appears in the schedule issued by the regulator, thus calculations by former results to figures which are not claimable by the holder and the entity does not hold a contractual right to receive cash against them. Hence, if we continue to accrue interest as per effective rate of interest then we record an asset:

a) At a value which is greater than its fair market value;

b) At a value against which the entity does not hold a contractual right to receive cash / benefits as the same are limited to what is calculated in the schedule provided by the issuer.

**Issue no. 2**

Another issue arises when it comes on to the distribution of funds to members' account based on the effective interest method. The attached case study highlights the fact that although the concept behind recording an investment held to maturity at amortised cost using effective interest method is to evenly spread the related returns over the life of the asset however, in this very particular case (DSC) where investment is held by a trust for the benefit of employees the purpose seems to be over ruled. Member retiring at any time between 1$^{st}$ and 10$^{th}$ (last) year subsequent to the investment is made not only receive different returns over the said investment but also the excess benefit enjoyed by one retiring member is actually the cost of those who remain employed as the profit credited to retiring members' account are actually not received from the certificate issuer.

A detailed case study is prepared and attached to this covering letter to further highlight the grey areas of the calculations made using effective interest method in the above context.

**Query**

In context of the above we would like to know:

a) Whether the interest accruing on Defence Saving Certificates (DSC) should be recorded in the books of accounts as per schedule provided by National Savings, Ministry of Finance, Pakistan.

**OR**

b) Alternatively we record interest in the books of accounts using effective interest method and withhold distribution to members' account by the differential amount arising from the two modes of calculations i.e. Effective interest method and the schedule provided by National Savings, Ministry of Finance, Pakistan.

We look forward towards your guidance in the above matter and would appreciate if you could reply to our queries at earliest.

**Opinion:**

Your attention is drawn to the ICAP Selected Opinion No. 1.16 of Volume No. VIII on "Recognition of interest on Defence Saving Certificates held by an Employee Provident Fund" which responds to your concerns:

> '*The definition paragraph 10 of IAS 39 explains the calculation of amortization to be used as the effective interest method. It is the rate that exactly discounts the expected stream of future cash payments through maturity, or the next market-based re-pricing date to the current net carrying amount of the financial asset or financial liability. That computation should include all fees and points paid or received between parties to the contract. The effective interest rate is sometimes termed the "level yield" to maturity or to the next re-pricing date and is the internal rate of return (IRR) of the financial asset or financial liability for that period.*
>
> *In view of the above discussions, the Committee is of the opinion that if the Defence Saving Certificates satisfy the criteria mentioned then these investments should be measured at amortized cost by applying effective interest rate method.'*
> ***(IAS 39, Volume 2003)***

With regard to your alternative option, the Committee considered your concerns and is of the view that withholding of differential amount arising between the effective interest method and the schedule provided by the National Savings, Ministry of Finance, Pakistan in the member's account would not be appropriate and may be tantamount to denying the members leaving the fund earlier their due share of income.

*(May 28, 2013)*

## 14. Impairment of AFS Investment as per IAS 39

### Enquiry:

ABC Company has made investment in shares and classified it as Available for sale investment. During the year the market value of shares is significantly below then its cost. As per paragraphs 67 to 70 of IAS 39 (2009 edition) its shares are impaired by Rs. 80 million, but in 2010 edition above paragraphs (67 to 70) have been deleted. Kindly advise us whether there is need to charge impairment or not. If yes and ABC Company refuse to charge impairment, what will be our course of action as an auditor? Please note that the above assets are marked to market and the resultant reduction in value has been charged to equity.

Some extract of financial information are:

| | | |
|---|---|---|
| Profit for the year (before impairment) | Rs. | 120 million |
| Profit for the year (if impairment charged) | Rs. | 40 million |
| Materiality | Rs. | 5 million |

### Opinion:

The Committee examined your enquiry and is of the view that para 67 to 70 of IAS 39 (2009 edition) will remain applicable until the Institute adopts IFRS 9 'Financial Instruments'.

*(June 27, 2012)*

## 15. Presentation / Disclosure Requirements (Investments – Held-To-Maturity)

**Enquiry:**

During previous years a Company purchased – 'Sukuk Bonds' (SB) for Rs.80.650 million, having face value of Rs.75.00 million. Company recognized and recorded 'Intangible Asset' for Rs.5.650 million (premium paid over and above face value and treated as transaction cost) to be amortized over 6.8 years, the maturity period of SB. Investments were disclosed in the financial statements at face value. As per auditors, no active market existed for the investments so fair market-value of the same could not be determined. As per accounting policy, interest income upon SBs was recognized by applying prevailing / applicable base rate plus points.

Accounting policy for investments was not disclosed in the financial statements. Investments classified as 'Held-to-maturity' were not disclosed in accordance with requirements of IAS-39.

**Recommendation**

When a financial asset or financial liability is recognized initially, an entity shall measure it at fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability (IAS 39, Para 43). Held to maturity investments should be measured at amortized cost, using the effective interest method. In this case, company recognized interest income upon the investments using applicable base rate plus points, the same rate could be applied to calculate the amortized cost of the investments.

**Statistics of the case:**

Sukuk Bonds (SBs) purchased for Rs. 25.0 million
Number of bonds (Rs. 25.0 million / 100) = 250,000 bonds
Face value: Rs. 100
Purchased at premium Rs.2 per bond Rs. 2.0 million in total
Date of purchase: July 1, 2006
Date of maturity: June 30, 2012
Rate of profit: 6 months KIBOR plus 35 basis points payable semi annually.
Year end is June 30, 2009
Sukuk Bonds are traded in a secondary market through brokers, like money market the way treasury bills are traded.

**In the financial statements:**

- SBs has been disclosed as held to maturity investment at Rs. 25.0 million;
- Premium has been capitalized to intangible assets at Rs. 2.0 million and is being amortized to date in the financial statements equally on a systematic basis over the period of maturity;
- Interest income being received bi-annually is taken to profit and loss account on simple accrual basis.

Please advice the treatment of above-mentioned case as per IAS 39 especially when KIBOR is rapidly changing. Amount of interest varies each time at the time of payment of profit.

**Opinion:**

Please refer to para 46(b) of IAS 39 *Financial Instruments: Recognition and Measurement* requires *held to maturity* investments to be measured after initial recognition, at the amortised cost using the effective interest method.

Please see the following definitions relating to recognition and measurement as provided in IAS 39:

**The *amortised cost of a financial asset or financial liability* is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.**

**The *effective interest method* is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. <u>When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument</u> (for example, prepayment, call and similar options) but shall not consider future credit losses. <u>The calculation includes</u> all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 *Revenue*), transaction costs, <u>and all other premiums or discounts</u>. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).**

For changing interest rate as referred to in the enquiry, guidance may be taken from the following paragraphs of IAS-39:

BC35 For consistency with the estimated cash flows approach, the Board decided to clarify that the effective interest rate is calculated over the expected life of the instrument or, when applicable, a shorter period. <u>A shorter period is used when the variable (eg interest rates) to which the fee, transaction costs, discount or premium relates is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date</u>. (Underlining is ours)

AG7 For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in profit or loss.

**Floating interest rate** is defined as an interest rate that, instead of being a fixed percentage, is stated as an amount above or below another rate, such as the prime rate. The interest rate moves up or down in relation to the rate of the controlling index.

The Committee would like to draw your attention to the measurement of amortised cost by using effective interest rate which should include the Premium amount. Therefore as mentioned in the enquiry, amortization of the same separately is not correct.

*(November 2009)*

## 16. Treatment of Investment In Associates in Separate Financial Statements

**Enquiry:**

A listed Company, in its separate financial statements for the year ended June 30, 2007, has disclosed following accounting policy for investments in associates and subsidiaries:

"*Investments in subsidiaries and associates are stated at cost and the carrying amount is adjusted for impairment, if any*.

The Company has made an equity investment in its associated company and has recorded that investment, in its separate financial statements, at cost in accordance with its accounting policy. During the year 2006 the Company decided to dispose of a portion of its investment in associate and transferred that portion from the category *"Investment in associates"* to "*Available for sale Investment*" and stated it at its fair value. During the year 2007 the said portion of investment was transferred back to the category "*investment in associate"* at its fair value on the date of transfer. The said action has been recorded in the books of the Company in following manner:

| | **2007 (Rs)** | **2006 (Rs)** |
|---|---|---|
| **Investment in Associates** | | |
| Investment in associates 61,917,188 (2006: 49,533750 shares) of Rs.10 each) Market value of Rs. 219.95 (2006:137.75 per share) | 1,772,546,770 | 1,862,802,950 |
| Less: transferred to available for sale investment - 2,400,000 shares of Rs 10 each | | (90,256,180) |
| Add: transferred from available for sale investments on reclassification - 2,400,000 shares of Rs 10 each | 527,880,000 | |
| | **2,300,426,770** | **1,772,546,770** |

This represents 7.65% share (2006: 7.65%) in the equity of 809.4 million shares of Rs. 10 each in the associated company. The Group as a whole controls 30.3% (2006: 25.5 %) equity in the associated company. Increase in number of shares represents bonus shares received.

| | | |
|---|---|---|
| **Available for Sale Investment** | | |
| Opening balance | 90,256,180 | - |
| Transferred from investment in associate (2,400,000 shares) | - | 90,256,180 |
| Surplus on re-measurement of available for sale investment to fair value as on July 01 | 240,343,820 | - |
| Surplus on re-measurement of available for sale investment to fair value for the year | 197,280,000 | 240,343,820 |
| | 437,623,820 | 240,343,820 |
| Transferred to investment in associate on reclassification | (527,880,000) | - |
| | **-** | **330,600,000** |

*NOTE: Last year as per management intention 2,400,000 shares of associate were transferred to available for sale Investments. During the year, pursuant to change in intention, these shares have been transferred back to investment in associate.*

The Committee is requested to consider whether the accounting treatment adopted by the Company is in violation of Company's accounting policy and the requirements of IASs.

**Opinion:**

The Committee has reviewed the above matter and its views are as under:

The accounting for investments in associates in the separate financial statements of an entity is dealt with under IAS-27 (read with paragraph 35 of IAS 28) which is effective for annual periods beginning on or after January 1, 2005. The said standards requires as under:

> 37 When separate financial statements are prepared, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 shall be accounted for either:
>
> (a) at cost, or
>
> (b) in accordance with IAS 39**.**
>
> The same accounting shall be applied for each category of investments. Investments in subsidiaries, jointly controlled entities and associates that are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 shall be accounted for in accordance with that IFRS' (underlining is ours).

It follows from the above that, in the context of separate financial statements, investments classified as associates should be accounted for either (a) at cost or (b) in accordance with IAS-39 depending on the accounting policy selected by a Company. In the case referred by you, the Company has chosen cost basis as its accounting policy for investment in associates. The accounting policy selected should have been applied to the entire category of investment on a consistent basis except in the following circumstances:

(i) the investment ceases to meet the criteria for classification as associate; or

(ii) the investee becomes a subsidiary or joint venture, in which cases it would expel out of the scope of IAS 28

In the above situations, the investment would need to be accounted for in accordance with other relevant standards i.e IAS 39, IAS 27 or IAS 31, as the case may be.

In the case under discussion neither of the above circumstances exist and as such, the entire category of investment needs to be valued on the basis of accounting policy initially selected i.e. "Cost Basis". As such, reclassification of part of investment from "Investment in Associates" to "Available for Sale" and vice versa and application of different accounting policies considering the parts as different category of investment was not in accordance with the provisions of the Accounting Standards.

*(June 7, 2008)*

## 17. Application of IAS – 39

### Enquiry

Our Company operates in a monopoly environment in the Gas sector in the provinces of Punjab and N.W.F.P. and obtaining finance on favorable terms from the Government and consumers is a regular feature in our case.

We have obtained concessional loans from the Federal Government, Government of Punjab, Government of N.W.F.P. and various industrial consumers with the mark up rate ranging from 1.5% to 5% respectively. We also maintain interest/non-interest bearing security deposit from consumers which carry interest below the market rates. We also have interest relating to the period from 1995 to June 2001) with zero interest charge (interest on interest is not applicable in Pakistan) payable to the Federal Government appearing under the head of other long term liabilities, the repayment of which was staggered over a period of 10 years in the year 2001.

In addition to the above, financial assets in the form of concessional loans have been given to our employees as part of our company policy and general industry practice.

All the above stated facts are a regular feature of our business and it is deemed that such assets and liabilities do not fall, within the scope of the IAS-39, it may not be possible for us to recalculate and restate these assets and liabilities through amortization in our accounts as the number of these transactions are in multiples of thousands. The basis of valuation of our assets / liabilities is being regularly disclosed in our Accounting Policy.

We have now been asked by our auditors to incorporate the impact of paragraph 46 and 47 of the revised version of IAS-39 Financial Instruments: Recognition and Measurement applicable to annual periods beginning on or after 1 January 2005 in the current financial year, requiring certain financial assets/ liabilities to be carried at their amortized cost using the effective interest rate method. The effective interest rate is further subject to interpretation.

We would like to point out that the previous version of the standard which was applicable from 1 January 2001, also required the same treatment for financial assets and liabilities, but our accounts never reflected these changes due to limitations stated above.

It is pointed out that none of the financial statements of quoted companies have so far incorporated the impact of IAS-39 in their accounts.

In the light of the above circumstances, it may not be possible to incorporate the changes in our Annual Accounts as stated in IAS-39. Owing to the nature of our business and the volume of work involved it is not practicable.

### Opinion

Financial Instruments are defined in paragraph 11 of IAS 32 *'Financial Instruments: Presentation'* as follows:

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

A financial asset is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) ………………….

A financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) ………………..

Further for measurement of financial instruments your attention is drawn to the following paragraphs 46 and 47 of IAS 39 *'Financial Instruments: Recognition and Measurement':*

46 After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:

(a) loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;

(b) held-to-maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and

(c) investments in equity instruments that do not have a quoted market price …………………

Subsequent measurement of financial liabilities

47 After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:

(a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 29 and 31 apply to the measurement of such financial liabilities.

(c) financial guarantee contracts ………………

## Conclusion

In view of the above paragraphs the Committee is of the opinion that loans from the Federal/ provincial governments, security deposit from consumers and loans to staff fall under the definition of financial assets/ liabilities, therefore, they should be dealt with as per the requirements of paragraphs 46 and 47 of IAS 39.

With regard to your statement that '*The basis of valuation of our assets / liabilities is being regularly disclosed in our Accounting Policy*' the Committee would like to draw your attention to the following paragraph of IAS 1 which is self explanatory:

> 16 Inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.

Further the Committee is also of the view that reasons for non-compliance with paragraphs 46 and 47 mentioned in your enquiry do not appear to be such which causes you to depart from the said requirement of the standards. For further detail you may refer to paragraphs 17 to 21 of IAS 1 *Presentation of Financial Statements*' which refers to circumstances where you are allowed to depart from a requirement of Standard or an Interpretation.

*(November 4, 2006)*

## 18. Interpretation / Implementation of IAS 39

### Enquiry

It is informed that scheduled commercial banks granted long term loan to industrial unit repayable at fixed rate of markup per annum in 20 half yearly equal installments.

Industrial unit due to financial crises could not pay installments of loan on due dates including accrued mark up. As per the decision of Baig Committee appointed by Government of Pakistan rescheduled all stuck up loans for revival of textile industry.

During rescheduling the accrued mark up was also included as part and parcel of the amount of loan rescheduled and as per BPD (Banking Policy Department) Circular No. 37 dated November 7, 1995 of the State Bank of Pakistan and subsequent circulars issued in this connection, the charging of mark up on accrued mark up capitalized was forbidden.

Accordingly, the scheduled bank to rectify the mistake segregated the rescheduled amount of loan in the following three categories.

a) The balance outstanding principal amount of loan was rescheduled to be repayable in 20 half yearly equal installments of Rs.0.953 million w.e.f September 1, 1999 to August 31, 2009 @ fixed mark up rate of 14% per annum.

b) The balance amount of accrued mark up inadvertently included in rescheduled amount was classified as deferred mark up repayable in 20 half yearly equal installments of Rs.0.623 million w.e.f. September 1, 2009 to August 31, 2019 @ zero % mark up rate per annum.

c) The amount of mark up charged on mark up capitalized amounting to Rs.4.192 million shall be waived.

In view of the above, we seek your clarification regarding the following questions:

a) Should the original loan amount repayable in 20 half yearly equal installments payable @ 10% per annum (reduced from 14% per annum) be shown at its present value in terms of IAS-39?

b) Should the amount of Accrued mark up freezed and repayable in 20 half yearly equal installments w.e.f. September 1, 2009 to August 31, 2019 be classified as a loan in term of IAS-39 and how to work out its present value @ zero % mark up rate?

### Opinion

The Committee first would like to draw your attention towards the following paragraphs of IAS 39:

**“Derecognition of a financial liability**

39 An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished- i.e. when the obligation specified in the contract is discharged or cancelled or expires. (Underlining is ours).

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

**AG57** A financial liability (or part of it) is extinguished when the debtor either:

a. discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

b. is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met). (Underlining is ours).

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

It follows from the above that if the rescheduling arrangement meets the above criteria of "substantial modification of terms", the accounting treatment would be as follows:

a) The carrying amount of original loan should be derecognized;
b) The new or rescheduled loan should be recognized which has to be initially measured at fair value (for further guidance, you may refer to the following paragraphs of IAS 39 and its application guidance); and
c) The difference between (a) and (b) above should be taken to the profit and loss account.

**"Initial measurement of financial assets and financial liabilities**

43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

**Initial measurement of financial assets and financial liabilities (paragraph 43)**

AG64 The fair value of a financial instrument on initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received, see also paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated using a valuation technique (see paragraphs AG74–AG79). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

AG65 If an entity originates a loan that bears an off-market interest rate (e.g. 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee

> as compensation, the entity recognises the loan at its fair value, i.e. net of the fee it receives. The entity accretes the discount to profit or loss using the effective interest rate method."

Where the financial liability is not extinguished and does not qualify for derecognition in accordance with the criteria as referred to in the above paragraphs, the modification to the financial liability consequent to renegotiation with the banks may be accounted for under one of two treatments for which support can be found in IAS 39. However, the chosen treatment should be the most appropriate treatment in the particular facts and circumstances of the transaction being accounted for. These treatments are as follows:

1) the difference between the previous carrying amount and the present value of the new cash flows discounted at the original effective interest rate is recognised immediately as a gain or loss in the profit and loss account; or

2) the effective interest rate of the liability is adjusted for the difference between the previous carrying amount and the present value of the new cash flows discounted at the original effective interest rate and accordingly this difference is recognised in the income statement over the remaining life of the liability.

*(March 9, 2007)*

## 19. Measurement of Interest Free (Low Interest Rate Loans Received/ Advanced by Companies

**Enquiry:**

Many companies have received from / advanced loan to related parties mainly associated companies, which are long term in nature and carry low interest rate or bear no mark up.

As per paragraph 43 of IAS 39 "when a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value"

Further as per example given in AG 64 "the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument"

**Query**

1. Should all the companies who have received interest free loan from associated company, record the loan at its fair value and account for any resultant gain in income for the year?

2. What will be the consequences of deferred taxation (if any) to be recognized (under para 15(c)(ii) of IAS 12), on this transaction?

**Opinion:**

Financial Instruments are defined in paragraph 11 of IAS 32 as follows:

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

A financial asset is any asset that is:

(a) cash;
(b) an equity instrument of another entity;
(c) a contractual right:

 (i) to receive cash or another financial asset from another entity; or
 (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or ………………….

A financial liability is any liability that is:

(a) a contractual obligation:

 (i) to deliver cash or another financial asset to another entity; or
 (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) ………………..

**CONCLUSION**

In view of the above the Committee is of the opinion that loans/advances to or from related parties fall under the definition of financial instruments and should be dealt with as per the requirements of paragraphs 45 to 47 and AG64 to AG66 of IAS 39. As per the requirements of the aforesaid paragraphs loan received or given to a related party that carries no interest or bears an off-market interest rate should be measured at fair value which would be the present value of all future cash receipts and payments discounted using the prevailing market rate(s) of interest for a similar instrument. Any resultant gain or loss should be charged to profit and loss account.

However while measuring the fair value of financial assets or financial liabilities you are advised to take cognizance of the following paragraph of IAS 39:

49 The fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

With regard to your second, the Committee is of the opinion that deferred tax liability or asset may appear to arise.

*(January 5, 2007)*

## 20. Re-Classification of the Shares

### Enquiry

PQR Corporation Limited (PQR) acquired the rights to manage two closed-end funds i.e. The Growth Fund (TGF) and The Investment Fund (TIF) in the privatization process from XYZ Corporation of Pakistan (XYZ) on December 13, 2002 and May 3, 2003 respectively.

The above mentioned dates represent the signing of the Management Rights Transfer Agreement (MRTA) amongst XYZ, PQR and Privatization Commission. Pursuant to these agreements the status of shares of A, B, C and D held in these two funds were ascertained from XYZ through our two correspondences. In reply we were informed that these shares form a part of strategic shareholding under control of Government of Pakistan, thus implying that they are not to be sold and be treated as frozen.

Subsequently, D being a private entity was removed from the list and consents agreements were executed for 'C' and 'A' shares. Furthermore, privatization of 'C' led to reduction in the frozen holdings and at present only two frozen entities are left with Funds i.e. 'A' and 'B'.

As a matter of prudent investment policy these shares were Held for Trading (HFT), marking them to market every year. These frozen holdings constitute almost 50% portfolio of TGF and 25% portfolio of TIF. It has been consistently observed that our performance in non frozen holdings gets overshadowed by the dispositions of these mammoth frozen chunks.

Unfortunately, the International Accounting Standard – 39 (IAS 39) in its paragraphs 50 to 54 does not permit reclassification of shares once classified as HFT. Since the concept of IAS 39 revolves around the notion of realizable price and these shares are not for sale therefore we seek your opinion whether we can reclassify these shares as Long term strategic.

The core benefit of transferring these holdings into AFS is rationalization of Profit & Loss Account through lower volatility. Moreover, the concept of keeping a security in HFT is valid only if it is tradable which is not the case as these securities are not tradable by their very nature and provide a misleading picture to the certificate holders.

### Opinion:

Your attention is drawn to the following paragraphs of the revised International Accounting Standard (IAS) 39; "Financial Instruments: Recognition and Measurement", which is applicable to financial statements covering annual periods beginning on or after January 1, 2005:

"Definitions of four categories of financial instruments (paragraph 9 of IAS 39)

A *financial asset or financial liability at fair value through profit or loss* is a financial asset or financial liability that meets either of the following conditions.

(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:

   (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

   (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

   (iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either:

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures* (as revised in 2003)), for example the entity's board of directors and chief executive officer."

"**Reclassifications**

50 An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued".

It follows from the above that almost any financial asset within the scope of IAS 39 may be classified as a financial asset at fair value through profit or loss if it is either (i) classified as held for trading; or (ii) <u>specifically designated as such by the entity at the time of initial recognition.</u> In addition, once a financial asset has been classified as a financial asset at fair value through profit or loss, it can not be subsequently reclassified into any other category. Accordingly, even if the investments made by TIF and TGF do not meet the criteria of held for trading given above, these investments may still be classified under the revised IAS 39 as a financial asset at fair value through profit or loss if these are designated as such by the entity.

You would be aware that the revised IAS 39 which became applicable to financial statements covering annual periods beginning on or after January 1, 2005 provided the following transitional provision to an entity to <u>re-designate</u> previously recognized financial assets as either "financial assets at fair value through profit or loss" or as "available for sale", as per the definition given in the revised IAS 39:

"**105 When this Standard is first applied, an entity is permitted to designate a previously recognised financial asset as available for sale. For any such financial asset the entity shall recognise all cumulative changes in fair value in a separate component of equity until subsequent derecognition or impairment, when the entity shall transfer that cumulative gain or loss to profit or loss. The entity shall also:**

**(a) restate the financial asset using the new designation in the comparative financial statements; and**

**(b) disclose the fair value of the financial assets at the date of designation and their classification and carrying amount in the previous financial statements."**

However, the Committee understands that the above transitional provisions of revised IAS 39 was not taken into account at the time of preparation of these financial statements and the investments were inadvertently continued to be classified as "Held for Trading".

In this specific case, the Committee would like to draw your attention to the following paragraphs of International Accounting Standard (IAS) 8, "Accounting Policies, Changes in Accounting Estimates and Errors":

**"Definitions (paragraph 5 of IAS 8)**

***Prior period errors*** **are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:**

**(a) was available when financial statements for those periods were authorised for issue; and**

**(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.**

**Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, <u>oversights</u> or misinterpretations of facts, and fraud".** (Underlining is ours)

**"42 Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:**

**(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or**

**(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented."**

**"Limitations on retrospective restatement**

**43 A prior period error shall be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error.**

**44 When it is impracticable to determine the period-specific effects of an error on comparative information for one or more prior periods presented, the entity shall restate the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable (which may be the current period).**

**45 When it is impracticable to determine the cumulative effect, at the beginning of the current period, of an error on all prior periods, the entity shall restate the comparative information to correct the error prospectively from the earliest date practicable."**

Accordingly, the Committee is of the view that if at the time of initial recognition the restrictions on disposal of these investments in the frozen shares of 'A' and 'B' was in place, the classification as held for trading at the time of initial recognition did not meet the criteria for held for trading financial assets as allowed under the revised IAS 39. Therefore, such classification may be treated as a prior period error and the Funds may rectify the error though the application of above referred provisions of IAS 8.

However, it should be clearly understood that financial assets and liabilities once classified cannot be reclassified. This exemption through the use of IAS 8 is only available where despite availability of all material information at the time of initial recognition due to an error or omission the instruments are wrongly classified. Therefore, use of this procedure to correct or rectify any situation which comes to light after the initial recognition of any instruments will not be appropriate.

*(February 9, 2007)*

## 21. Valuation of Unquoted Investment

### Enquiry

After the applicability of IAS 32 and IAS 39 in Pakistan, the concept of valuation of financial assets and financial liabilities at fair value is broadly followed. Consequently, equity investment in an unquoted company by a listed company, in most of cases, is measured at fair value being the break up value of the shares held, based on the latest financial statements of the investee.

Ours is a listed company which has short term investment in an unquoted insurance company XYZ Limited, a group company of MND Group. We hold approximately 9% of the equity of XYZ and have intentions to sell this investment within next few months. XYZ has significant investments in different listed companies including its own group companies. The accounting policy adopted for the valuation of these investments by XYZ and as stated in its audited financial statements for the year ended December 31, 2005 is setout below:

**"Paragraph 4.6**

**Investments**

The investments made by the company are classified for the purpose of measurement into the following categories:

a) **Held to Maturity** – Investments with fixed maturity that the management has the intent and ability to hold to maturity are classified as held to maturity and are initially recognized at cost being the fair value of consideration given and include transaction costs. At subsequent reporting dates these are measured at amortized costs using the yield method. Any premium paid or discounts availed on acquisition of such investments is deferred and included in income for the period on straight line basis over the term of investments.

b) **Available for Sale** - Investments classified as available for sale are initially measured at cost, being the fair value of consideration given and include transaction costs. Subsequent to the initial recognition at cost, these are stated at the lower of cost and market value, (market value being taken as lower if the fall is other than temporary), in accordance with the requirements of SRO 938 issued by the SECP in December 2002. The Company uses latest stock exchange quotations in an active market to determine the market value of its listed investments. The investment for which quoted market price is not available is measured at cost as it is not possible to apply any other valuation methodology.

At the subsequent reporting dates, the company reviews the carrying amounts of the investments to assess whether there is any indication that such investments have suffered an impairment loss. If any such indication exists the recoverable amount is estimated in order to determine the extent of the impairment loss, if any. Impairment losses are recognized as expenses.

This policy of stating available for sale investments at lower of cost and market value is not in compliance with IAS 39, which states that investments available for sale at subsequent reporting dates should be measured at fair value. The market value of available for sale investments as at December 31, 2005 is Rs. 4,061,132,654. Had the company complied with IAS 39, the carrying value of investments as at December 31, 2005 would have been higher by Rs.3,395,790,251"

The above non-conformity of compliance with IAS 39 is disclosed in audited financial statements of XYZ for the year ended December 31, 2005.

Our accounting policy for the valuation of investments available for sale is set out below:

These are stated at fair value and changes in carrying value are recognized as separate component of equity until investments are sold, disposed or until investments is determined to be impaired, at which the accumulated gain / loss previously reported in equity is included in income. For unquoted securities, fair value is determined considering the breakup value of the securities.

You would appreciate that the breakup value of XYZ is substantially understated as XYZ has not valued their investments in accordance with the measurement criteria provided by IAS 39 and accordingly is understating its available for sale investments and equity. Consequently the fair value of our investment in XYZ will not be stated at fair value in our books of account, if we adopt conventional method of valuing XYZ share at the breakup value disclosed in its accounts.

Had XYZ valued its investments in accordance with the measurement criteria given in IAS 39, the carrying value of investments and equity of XYZ as at December 31, 2005 would have been higher by Rs. 3,395,790,251. Accordingly breakup value used for the valuation of these investments in our company would also have been higher by the amount with which its equity would have increased. Our view in this regard is that while determining the fair value of our investment in XYZ, it is appropriate to adjust the equity of XYZ by the amount with which it is understated as at December 31, 2005.

**Opinion:**

Your attention is drawn to the following paragraph 46 of IAS 39:-

46 After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:

(a) ……………………….;
(b) ……………………….; and

(c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).

Further your attention is also drawn to the paragraphs AG74 to AG75 and AG 80 to AG82 of IAS 39:-

**No active market: valuation technique**

AG74 If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

AG75 The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

AG80 The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

AG81 There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

In view of the above the Committee is of the opinion that instead of adjusting the equity of the Insurance Company in which you have an investment it would be appropriate to measure such investment at fair value by using the valuation technique referred to in paragraph AG 74 provided it can be measured reliably.

*(November 4, 2006)*

## 22. Reclassification of Financial Assets Held For Trading into Available For Sale

### Enquiry:

Your opinion is required for the following matter in the light of International Accounting Standard – 39 (IAS -39) *Financial Instruments : Recognition and Measurement* whether reclassification is possible for financial assets from held for trading to available-for-sale or not.

As per IAS 39 we are of the view that reclassification is not permitted for financial assets held for trading to financial assets available-for-sale as per paragraph No. 107 which is as under:

> Because the designation of a financial asset as held for trading is based on the objective for initially acquiring it, an enterprise should not reclassify its financial assets that are being re-measured to fair value out of the trading category while they are held. An enterprise should reclassify a financial asset into the trading category only if there is evidence of a recent actual pattern of short-term profit taking that justifies such reclassification.

Based on the view that the company is not eligible to reclassify its investment in the category of financial assets available-for-sale if a company acquired an investment and shown under category of held for trading for the objective of generating a profit from short-term fluctuations in price but later on the investor decides to hold this investment for a longer period as it is more beneficial (profit in shape of dividend or bonus issues etc.) for the company due to better future prospectus of the investee company.

So we would be very thankful to you if you provide us your opinion on this issue whether reclassification is permitted in the light of the International Accounting Standard-39.

### Opinion:

The appropriate Committee of the Institute, apart from paragraph 107 of IAS 39 you have mentioned in your above query, would also like to draw your attention towards following question and its answer given in IAS 39 Implementation Guidance:-

**Paragraph 107**

Question 107-2

Reclassification to trading: decision to sell

If an enterprise decides to sell a financial asset that is not classified as held for trading in the near future, should it reclassify that asset into the held-for-trading category?

**Answer**

No. IAS 39.107 specifies that the designation of a financial asset as held for trading is based on the objective for initially acquiring it. A decision to sell a financial asset does not make that asset a financial asset held for trading. On the other hand, if the asset is part of a portfolio of similar assets for which there is a recent pattern of trading, for instance, a portfolio of treasury notes classified as available-for-sale financial assets, they would be reclassified into the trading category.

Further the Committee would also like to draw your attention towards the following paragraph of revised IAS, which has superseded both the paragraph 107 and question 107-2 of previous IAS 39:

## Reclassifications

***50. An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.***

In view of the above paragraph the Committee is of the opinion that IAS 39 does not appear to allow reclassification of financial instruments from 'Held for Trading' to any other category or vice versa.

*(June 4, 2005)*

## 23. IAS 39 – Financial Instruments – Fair Values In Financial Statements of Provident Fund

**Enquiry:**

Para 1(c) of IAS 39 excepts employers' assets and liabilities under employee benefit plans, to which IAS 19, *Employee Benefits*, applies.

Prima facie, Provident Fund assets (mainly investment in securities & shares in listed companies) could not be categorized as "employer's assets", therefore, the Recognition and Measurement criteria stipulated in the Standard becomes applicable as follows:

i. Investments in Government Savings Schemes or other Government or private debt instruments may not be categorized as "held for trading" since trustees do not invest for short-term gains.

ii. Investment in Government Savings Schemes or other debt instruments could be categorized as "held-to-maturity" investments in the normal course.

iii. Investment in shares and debt instruments listed on the stock exchange will fall to be categorized as "available-for-sale"

iv. Neither Investments nor debt instruments fall in the category of "Loans and receivables originated by the enterprise".

Para 66 – (Initial recognition) Investments purchased are to be recognized at cost (fair value of the consideration including the transaction costs).

Para 69- After initial recognition, fair values are to be substituted except in cases of:

(b) held-to-maturity investments

(c) where a quoted market price in an active market is not available.

Para 73 - Investments that have a fixed maturity are to be measured at amortized cost using the effective interest rate method.

**Gains and Losses on Re-measurement to Fair Value**

Para 103 –

(a) a gain or loss on a financial asset.. *"held for trading*" should be included in net profit or loss for the period in which it arises – **not applicable in case of a provident fund**

(b) a gain or loss on an "available for sale "financial asset should be either

(i) included in net profit or loss for the period in which it arises; or

(ii) recognized directly in equity, through the statement of changes in equity

Following aforesaid edict:

- Fair value of Government securities & debt securities listed on stock exchange would be purchase cost as these are "held to maturity" investments.

- Investment in shares listed on stock exchange may be "market" and the quoted price may be taken as "fair value"

Fair value gain under para 103 (b)(I) leads to distribution of unrealized gains, which presumably may balance out in the long run. However, some funds have rules restricting distribution of capital gains realized on disposal of investments. In such a situation, distribution of unrealized / gain in fair value could be taken as contravention of Provident Fund Rules in the Trust Deed. Where a restrictive rule exists, it seems that the only option available would be "recognition through equity".

**Opinion:**

Regarding the applicability of IAS 39 to retirement benefit plans, the Committee would like to draw your attention toward the following paragraphs of IAS 26 and IAS 39:

Retirement benefit plans are sometimes referred to by various other names, such as 'pension' schemes' , superannuation schemes or retirement benefit schemes'. This Standard regards a retirement benefit plan as a reporting entity separate from the employers of the participants in the plan. <u>All other International Accounting Standards apply to the reports of retirement benefit plans to the extent that they are not superseded by this Standard.</u> **(IAS 26)**

32. Retirement benefit plan investments should be carried at fair value. In the case of marketable securities fair value is market value. Where plan investments are held for which an estimate of fair value is not possible disclosure should be made of the reason why fair value is not used. **(IAS-26)**

This Standard does not change the requirements relating to:

(d) employee benefit plans that comply with IAS 26 *Accounting and Reporting by Retirement Benefit Plans*. **(IAS 39)**

From the above it may be inferred that IAS 39 does not apply to investments pertaining to retirement benefit plans and all provisions of IAS 39 which give the option of taking a gain or loss on an available-for-sale financial asset either to include in net profit or loss or to recognize it directly in equity, are not relevant in the case of provident fund investments. (IAS 39.103)

Moreover IAS 26 does not have a concept of equity or reserves. It instead has the concept of "Net assets available for benefits" which are defined as "assets of a plan less liabilities" (IAS 26.08). As such question of transfer of a gain or loss on valuing financial assets on fair value to an equity account in a provident fund does not arise.

As such all gains or losses arising out of application of IAS 26.32 whether realized or unrealized shall be credited or debited to members accounts.

However the trustees of a provident fund may provide in the rules a mechanism to prevent distribution of unrealized gains to members.

*(October 2, 2004)*

## 24. Accounting of Spread Transactions

**Enquiry:**

While appreciating the deliberations put in by the Committee in reaching the conclusion as given in Selected Opinion No. 1.2 Volume VIII we noted that for determining the nature of a transaction to be considered as a derivative transaction the Committee had relied upon the following elements of the transaction:

- That the transaction has no cost at inception and does not qualify to be recognized as either an asset or a liability but is a commitment.
- That the future sale has been undertaken to protect against the price risk from fluctuation in market price, and
- That the sale transaction can be independently completed through settlement of differentials in price on the settlement date of the transaction without actual delivery of underlying security.

Firstly, we would like to clarify that the so-called "Future transactions" carried out at the KSE are a misnomer. These are in fact forward delivery contracts and have no relevance to Future contracts traded on the international markets.

We analysed the spread transactions carried by us and noted that in case of spread transactions, these have the following characteristics:

- That at the time of purchase full amount is paid to the counter party against delivery of shares in CDC account of the respective Fund and it is not simply a commitment.
- That the future sales (forward date settlement contract) are undertaken simultaneously to book the spread and not to protect against price risk from fluctuation in market price.
- That the sale transaction is settled on future settlement date by delivery of shares against receipt of sale proceeds.

We feel that these transactions should be viewed in their substance i.e. one part of the transaction is to acquire certain shares for ready delivery against payment and the second part of the transaction (entered into simultaneously) is to sell the same shares for delivery at a future date (forward settlement date) against payment may have a credit risk (relating to settlement at the exchange) rather than price risk from fluctuations in the market.

Under such circumstances, we understand that the view formed by the Committee for derivative transactions and the accounting treatment proposed by para 153 of IAS 39 for hedge transactions should not apply to these transactions.

Kindly confirm our understanding at your earliest in view of the close of the financial year on 30 June 2003.

**Opinion:**

The Committee has considered your observations on its earlier letter and the nature of transactions explained by you. The Committee stands by its initial opinion.

However, the Committee finds it pertinent to add that if the conditions stipulated in para 142 of IAS 39 are not met, alternatively, gains and losses on remeasurement to fair value may be accounted for under para 103(a) of IAS 39 which is reproduced below:

" 103. A recognised gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 121-165) should be reported as follows:

(a) a gain or loss on a financial asset or liability held for trading should be included in net profit or loss for the period in which it arises (in this regard, a derivative should always be considered to be held for trading unless it is a designated hedging instrument – see paragraph 122); "

We hope you would appreciate that the communication from the Technical Directorate of the Institute is for the assistance of members of the Institute and is not and should not be taken to be a directive of the Council. Hence, while the Committee stands by its above opinion, the members are free to obtain appropriate advice from their consultants or advisors.

*(August 9, 2003)*