The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

Selected Opinions

Volume XXIV

From July 1, 2018 to June 30, 2019

Technical Services Department

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Introduction

This is the twenty fourth compilation of opinions issued by the Institute's Accounting Standards Board (the Board) and the Auditing Standards & Ethics Committee (the Committee) on the enquiries raised by members, entities and regulators during the period from **July 2018 to June 2019.** This compilation of opinions is termed as "Selected Opinions".

These selected opinions are issued for the general guidance of the members of the Institute. In this document, the accounting opinions represent the opinions of the Board and opinions related to auditing and ethical matters represent the opinions of the Committee. These are not the official opinions of the Council of the Institute. The opinions are operational in nature and not on issues on which relevant laws and rules are not explicit. These selected opinions are not a compendium of "legal advice".

The opinions are based on the accounting and auditing principles on the date the Board and the Committee finalises the particular opinion. The date of finalisation of each opinion is indicated along with the opinion. Since an opinion is arrived at on the basis of the facts and circumstances of each individual query provided by the enquirer, it may change if the facts and the circumstances change. An opinion may also change due to subsequent developments in law, pronouncements made by the Institute and other relevant changes. The Institute, the Board and the Committee will have no liability in connection with such opinion.

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

Directorate of Technical Services

1.1 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)

1.2 Accounting treatment of foreign exchange losses due to recent depreciation of PKR, used for acquisition of revalued property, plant and equipment

Enquiry:

In recent years the Company has imported some machines financed through long term foreign currency loan. As per IAS -16 (Property Plan & Equipment) we are measuring these assets under revaluation model. Resultant surplus is credited to 'Revaluation surplus Account'. On the other side, foreign currency loan to finance these assets is re-translated at each reporting date as per IAS 21 (foreign Currency), any foreign exchange gain / loss is charged to income statement.

Recent devaluation of PKR has the following impact:

- Increase in market value of machines which is currently accounted for as revaluation surplus under IAS 16 through comprehensive income; and

- Recognition of exchange loss in income statement under IAS 21 on foreign currency loan Impact of devaluation in foreign currency loan is recognized in profit & loss which reduce the reported profit and EPS while impact of revaluation surplus in recognized though other comprehensive income (OCI) having no impact on EPS.

We are of the view that due to special nature of transaction impact of devaluation (exchange loss) should either be routed though OCI instead of P&L or the revaluation surplus should be routed through P&L under matching principals of accounting. Please give your opinion so that we can prepare financial statements in light of your opinion.

Opinion:

With regard to the enquiry the Board would like to highlight that the applicable financial reporting framework in Pakistan has been specified in section 225 of the Companies Act, 2017. The requirements of the section 225 and third schedule of the Companies Act, prescribe the financial reporting framework of listed companies to include IFRS notified by the Securities and Exchange Commission of Pakistan (SECP), and provisions of and requirements of Companies Act. Further, section 225 also empowers the SECP to adopt, grant exemption and enforce financial reporting requirements.

The Board notes that the accounting requirements referred to in the enquiry, for revaluation surplus under IAS 16 *Property, Plant and Equipment* and foreign exchange losses under IAS 21 *The Effects of Changes in Foreign Exchange Rate* are independent of each other, i.e. are not based on the cause and effect basis. Further, IAS 33 *Earnings Per Share* requires the Company to present basic Earnings Per Share (EPS) and diluted EPS, and also allows a company to disclose additional basic and diluted earnings per share.

In accordance with IAS 1 *Presentation of Financial Statements*, the performance of a company is reported in the statement of profit or loss and other comprehensive income. Understanding an entity's financial performance for the period requires an analysis of all recognised income and expenses (including income and expenses included in other comprehensive income), as well as an analysis of other information included in the financial statements.

Profit or loss is defined in IAS 1 as the total of income less expenses, excluding the components of other comprehensive income. Whereas, other comprehensive income is defined as the items of income and expense (including reclassification adjustments) that are not recognized in profit or loss as required or permitted by other IFRSs. The Conceptual Framework does not provide any broad principles as to which items of income and expenses should be reported in the other comprehensive income. However, the specific items have been mentioned in the

IFRSs that should be presented in the OCI. Accordingly, it is down to individual accounting standards to direct when gains and losses are to be reported in OCI.

The Board notes that the businesses, in general, are likely to be exposed to foreign exchange risk arising from volatility in the currency markets. Accordingly, IFRSs expect entities to properly identify, anticipate and manage volatility in equity and the income statement through financial risk management objectives and strategies. In this regard, companies that are reporting under IFRSs can use different techniques, including hedging to safeguard against unfavorable foreign currency risks. Consequently, under IAS 21, the exchange losses arising on the translation of foreign currency monetary items (e.g. a foreign currency loan) are an indicative of the performance of the company and accordingly reported in the statement of profit or loss.

Further, the Board would like to highlight that the paragraph 73 of IAS 33 allows companies to disclose additional EPS figures calculated using numerators other than those required by IAS 33. In context of the enquired scenario, the company may consider and evaluate the disclosure of additional EPS and additional diluted EPS in the notes to the financial statements, based on the adjusted profit or loss that is reflective of management key financial performance measures, in accordance with the IAS 33.

Moreover, the Board understands that the recent changes in foreign exchange rate (US dollar to Pakistan Rupee) are market driven, affecting all the entities in Pakistan. The IFRS Interpretation Committee takes an agenda item for further consideration, if the matter is widespread and has, or is expected to have, a material effect on those affected. With regard to matter raised by the enquirer, so far, DTS has not received any other enquiry or request from a member, regulator or other stakeholders.

Based on the above discussion, the Board concludes that the company shall follow the requirements of IFRSs related to the revaluation surplus, exchange losses on foreign currency loan and EPS, as adequate basis and guidance in provided thereunder.

(July 24, 2018)

1.3 Application of IAS 12 *Income Taxes* on recognition in profit and loss account/equity of surplus retained in statutory funds of life insurance companies

Enquiry:

Insurance Accounting Rules, 2017 and Insurance Accounting Regulations, 2017 have prescribed the format for the published financial statements of life insurance companies which include a single balance sheet, statement of comprehensive income and cash flow statement. These have amended the composition and presentation of statutory funds in the published financial statements segregating these as insurance liabilities and shareholders fund (equity). Ledger Accounts C and D in the statutory funds represent the funds / retained earnings attributable and distributable to shareholders (if above the solvency margins) and accordingly classified in equity.

The ASB is requested to share its opinion on whether surplus retained in ledger accounts C and D be termed as a permanent difference in the light of IAS 12 *Income Taxes?*

Opinion:

The Board notes that in context of enquired matter, guidance can be obtained from IAS 12, *Income Taxes*.

IAS 12 outlines the requirements for the current and deferred taxation and underlying concepts of permanent and temporary differences.

IAS 12 defines a deferred tax liability as *the "amounts of income taxes payable in future periods in respect of temporary differences"*.

The temporary and permanent differences are briefly discussed below:

- A temporary difference refers to a difference between the tax base of an asset or liability, determined based on recognition and measurement requirements for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Therefore, deferred tax is the amount of income tax payable (recoverable) in future period as a result of past events and transactions.

- Although IAS 12 does not define the term "permanent difference", entities consider the effects of permanent differences on the measurement of deferred tax assets and deferred tax liabilities under IAS 12. The events or transactions that do not have tax consequences when a basis difference reverses do not give rise to temporary differences. These situations are typically referred to as "permanent differences".

Under IAS 12 a deferred tax liability is required to be recognized for all taxable temporary differences, except to the extent that the deferred tax liability arises from initial recognition of goodwill or initial recognition of assets and liabilities in a transaction which is not a business combination and affects neither accounting nor taxable profit at the time of transaction. Temporary differences represent the differences between the carrying amount of assets and liabilities in the financial statements and their tax base.

Further, in accordance with paragraph 39 of IAS 12, an additional exemption applies to taxable temporary differences related to investments in subsidiaries, branches and associates, and interests in joint venture, if certain criteria are met.

The relevant paragraphs 15 and 39 of IAS 12 are reproduced below:

> *"15 A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:*
>
> *(a) the initial recognition of goodwill; or*
>
> *(b) the initial recognition of an asset or liability in a transaction which:*
>
> *(i) is not a business combination; and*
>
> *(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).*
>
> *However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39."*
>
> *"39 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:*
>
> *(a) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and*
>
> *(b) it is probable that the temporary difference will not reverse in the foreseeable future."*

In this context, the exceptions from the recognition of deferred tax liability have been specifically outlined in the IAS 12, and drawing an analogy of the under discussion scenario of life insurers with the above exception/s would not be in accordance with the IAS 12 requirements.

Taxation of the life insurance companies is governed by the 4th Schedule to the Income Tax Ordinance 2001. Under the 4th Schedule, only so much of the surplus generated in the statutory fund, as is approved for transfer to the shareholders' fund by the appointed actuary, shall be considered as the taxable income of the life insurer, and the undistributed surplus shall not be taxed.

IAS 12 explains that the taxable income is determined in accordance with the rules established by tax authorities; consequently, this may not necessarily be the same as accounting profit. Further, the tax provision for a given year as computed under IAS 12 represents not only the amounts currently due, but also the change in the cumulative future tax consequences of items that have been reported for financial reporting purposes in one year and taxable income purposes in another year (i.e., deferred tax).

Under the previous formats for the financial statements, there was no difference in the carrying amount and the tax base of assets and liabilities pertaining to a statutory fund and as such, no deferred tax was required. However, the Insurance Accounting Regulations 2017 have changed the nature of ledger accounts C and D to equity (previously shown below equity), whereas ledger accounts A and B are to be treated as liabilities, until any amount is transferred into ledger account C.

The Board (based on the DTS research of the few international accounting practices in the life insurance sector) notes that perhaps there is only one country, i.e. Kenya, where the taxation regime in respect of the surplus of the statutory fund is comparable with Pakistan. This may be the reason that this particular issue of deferred taxation of perpetual nature is not widely discussed in the interpretations of the accounting standards and other recognised accounting literature other than the principle requirements of IAS 12.

The Institute of Certified Public Accountants of Kenya (ICPAK) in December 2014 issued guidance on treatment of deferred tax on the actuarial surplus of life insurance companies.

Based on the guidance issued by ICPAK we understand that there is similarity in the Kenyan and Pakistan Insurance regulatory regime. The life insurance businesses (assets and liabilities) in Kenya are managed separately and are ring fenced from a taxation perspective. In the financial statements, life insurance businesses prepare separate statements of comprehensive income and statement of financial position. The profit for the year is transferred to the actuarial surplus (commonly referred to as the statutory reserve) on an annual basis. The net carrying value of assets and liabilities on the statement of financial position is represented by the actuarial surplus (statutory reserve).

The ICPAK through this guidance concluded that the actuarial surplus in substance represents profits and losses recognised in the income statement of the life insurance business which have not been recommended for transfer for the benefit of shareholders and therefore not taxed. Even though the profits and losses were recognised from an accounting perspective, they only affect taxable profits once recommended for transfer for benefit of shareholders by an actuary. Therefore, the difference between the tax base of the actuarial surplus and the carrying amount of nil is a taxable temporary difference that gives rise to a deferred income tax liability. The ICPAK concluded in its guidance that a deferred tax liability should be recognized on the actuarial surplus of a life insurance company.

The maintenance of solvency margins in the statutory funds is a regulatory requirement for the life insurers. With reference to ledger accounts C and D, an amount is 'locked-in' for solvency purposes, though, in substance/principle, this amount pertains to the shareholders of the company. This locked-in amount of ledger accounts C and D would be available to shareholders for distribution, in case of liquidation of company or significant change in the operations/change in tenure of the policies. For maintenance, of solvency margins in ledger accounts C and D, the SECP may consider allowing the solvency margins though calculated on individual statutory fund basis, to be kept separately in reserves at shareholders' fund level. This would settle the issue of income tax and deferred tax. The transfer of solvency margin from ledger accounts C and D to a separate reserve in shareholders' fund would be subject to current tax and the question of providing deferred tax on solvency margins maintained inside a statutory fund would not arise.

IAS 12 generally does not take into account the timing of reversal of a taxable temporary difference, accordingly, the fact that some or all of the differences may not be expected to crystalize in the future is not relevant under IAS 12. Therefore, an entity might be able/required to delay a tax effect indefinitely; the ability to do so is not a factor in determining whether a taxable temporary difference exists.

Further, the amount retained in the ledger accounts C and D is based on the actuarial calculations (as transfer to shareholders' fund is made on the actuarial recommendation). This surplus is linked to the life insurers policies, and would be released to the benefit of the shareholders over the life of the policy(ies). Therefore, the surplus does not remain undistributed in perpetuity.

Based on the above discussion the Board concludes that the maintenance of solvency margins by life insurers in ledger accounts C and D cannot be termed as a permanent difference in accordance with the IAS 12.

There exists a taxable temporary difference, in terms of IAS 12, associated with the surplus retained in ledger accounts C and D of the statutory funds, as this surplus would eventually be transferred to shareholders' fund and available to be distributed to the shareholders in the event of winding up, change in level of insurance business and/or insurance policies, and hence, taxable. The timing of reversal of deferred tax liability related to the surplus retained in ledger accounts C and D is not a factor, which would hinder in the recognition of the deferred tax liability.

(October 18, 2018)

1.4 Accounting and presentation of compensation for delayed delivery of vehicles

Enquiry:

The Engineering Development Board (EDB) introduced certain measures to be taken for consumer welfare under the Auto Development Policy 2016-21 (ADP) due to long lead times of vehicle supply from date of booking till delivery on account of production limitations.

This included payment of 50% advance and offering compensation to customers. The relevant paragraph of the ADP is reproduced below:

> *"Any delay over two months shall result in discount @ KIBOR + 2% prevailing on the date of final delivery / settlement from the final payment, which shall help shorten delivery lead time."*

Since majority of the steps and measures introduced under the ADP were implemented through various SROs under Customs Act and other laws and no such SRO has been issued to enforce the above measure, there is no legal binding for the above measure.

However, the Company voluntarily adopted the above measure as a best corporate practice for a specific category of customers. Accordingly, the Company introduced a policy to compensate a specific category of customers for the advances held by the Company where delivery of the ordered vehicle is made after two months, despite the fact that delivery time is already agreed with the customer at the time of order. The Company reserves the right not to pay such mark up to any company in line with its policy.

The contract for sale of automobile with the customer is made through a Provisional Booking Order (PBO) form. The Company does not have any conditions with respect to payment of mark up on delayed delivery in the PBO form or any other contract with the customer.

The Company has included the compensation for delayed delivery paid to the customers in the "Finance Cost" in the financial statements for the years ended June 30, 2017 and 18. Further, this amount is disclosed in the notes to the financial statements as "Mark up on advances received from customers".

The rationale for recording this amount as a finance cost is due to the fact that its calculation is linked to the interest rate (i.e. KIBOR) and time period for the delay.

In view of the above facts and circumstances, whether the current practice of the Company in respect of presentation of compensation for delayed delivery is in accordance with the International Financial Reporting Standards (IFRS) and other locally applicable regulations.

Opinion:

The Board noted that the enquiry relates to the accounting and presentation of the compensation paid/payable to the customers for delayed delivery of vehicles. In this regard, Board noted that guidance should be obtained from IFRS 15, *Revenue from Contracts with Customers*, which outlines various aspects of the revenue recognition, including compensation/penalty payable by an entity to a customer.

It is pertinent to mention that IFRS 9, *Financial Instruments*, through paragraph 2.1 (j) scopes out financial assets and financial liabilities that represent rights and obligations within the scope of IFRS 15, except those which IFRS 15 specifies to be accounted for in accordance with IFRS 9.

The Company's obligation to compensate customers for delayed delivery of vehicles originates from transactions involving sale of vehicles to customers. In context of the enquired scenario guidance of IFRS 15 relating to the determination of transaction price is relevant.

Paragraph BC18 of IFRS 15 outlines that upon entering into a contract with a customer, an entity obtains rights to receive consideration from the customer and assumes obligations to transfer goods or services to the customer (performance obligations). The combination of those rights and performance obligations gives rise to a (net) asset or a (net) liability depending on the relationship between the remaining rights and the performance obligations.

In accordance with IFRS 15, an entity is required to recognise revenue at the amount of transaction price, which is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The consideration promised in a contract with a customer might include fixed amounts, variable amounts, or both. Further, the contractually stated prices for goods or services might not represent the amount of consideration that an entity expects to be entitled to as a result of its customary business practices with customers. Furthermore, IFRS 15 also provides guidance on accounting for amounts that an entity pays, or expects to pay, to the customer.

The Board noted that though the provisional booking order (used for booking of vehicle by the customer) of the Company form does not explicitly state that the Company shall pay any compensation to the customer for delayed delivery of vehicle. However, in accordance with IFRS 15, the Company's adopted best practice to pay compensation for delayed delivery to a specific category of customers, implicitly affects the transaction price under IFRS 15.

In accordance with paragraph 48 of IFRS 15, while determining the transaction price an entity is required to consider the effects of all of the following:

- Variable consideration
- Significant financing component
- Consideration payable to a customer
- Non-cash consideration

With regard to the variable consideration, IFRS 15 outlines that the consideration promised in a contract with a customer may include variable amount/s, and can take many forms (e.g. discounts, liquidated damages, rebates, refunds, credits, price concessions, outcomes-based pricing, milestone payment, performance bonuses and penalties). The variable consideration can result from explicit contract terms or can be implied by entity's past business practices or intentions under a contract. As explained in paragraph BC191 of IFRS 15 the consideration can be variable even in cases in which the stated price in the contract is fixed.

Under IFRS 15, if the consideration promised in a contract includes a variable amount (either explicit or implied), an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer. Variable consideration is measured using either a 'probability weighted' or 'most likely amount' approach, whichever is most predictive of the final outcome. In accordance with paragraph 55 of IFRS 15, an entity recognises a refund liability for consideration received or receivable if it expects to refund/repay some or all of the consideration to the customer. Further, variable consideration must be estimated at contract inception, and shall be reassessed at each reporting period.

In accordance with IFRS 15, consideration payable to a customer is another relevant aspect that may affect the transaction price. Paragraph 71 of IFRS 15 outlines that the consideration payable to a customer is recorded as a reduction of the transaction price, thereby reducing the amount of revenue recognised, unless the payment is for a distinct good or service received from a customer. Additionally, if this amount is variable, the variable consideration constraint must be assessed.

Further, in accordance with IFRS 15, contracts in which payment by the customer and performance by the entity occur at significantly different times need to be assessed to determine whether the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms. In this context the factors outlined in paragraphs 61 and 62 of IAS 15 shall be considered by the entity. Interest income or interest expense resulting from a significant financing component should be presented separately from revenue from contracts with customers. In the scenario mentioned in the enquiry, the Board understands that the customer pays the consideration for purchase of vehicle in advance and as such, there is no financing component for the benefit of the customer in the transaction price. On the other hand, the advance payment of the consideration to the company does not appear to be for financing the production of the product to be delivered to the customer. Further, as a practical expedient, IFRS 15 allows the effects of a significant financing component to be not accounted for if the entity expects, at contract inception, that the period between the transfer of a promised good or service to the customer and the date of payment will be one year or less.

Based on the, the Board concluded that the Company’s voluntarily adopted practice to compensate customers for delayed delivery of vehicles originates from transactions involving sale of vehicles to customers. Under the IFRS Standards, IFRS 15 contains the relevant guidance for accounting and presentation of compensation payable to a customer under a contract with customer. The payments/payable amounts of compensation to a customer shall be accounted as a reduction of revenue and disclosures are provided in the financial statements, in accordance with IFRS 15.

(November 15, 2018)

1.5 Treatment of retained balance in Participants' Takaful Fund of Window Takaful Operations in published financial statements

Enquiry:

Another inconsistency arising out of the implementation of the Insurance Accounting Regulations, 2017, where nothing has been specifically prescribed for the Window Takaful Operations, is the treatment of the surplus arising in the Revenue Account of the Participants' Takaful Fund. Your kind attention is drawn to the fact that under Clause 4.5 of the Waqf Deed of the Individual Family Takaful Fund of the Company, the surplus arising in the Participants' Takaful Fund relates to, and can be distributed only to the participants, under the advice of the Appointed Actuary and the Shari'ah Advisor; and does not relate to the life insurance company or its shareholders. Hence, essentially, although as per the current formats as prescribed in the Insurance Accounting Regulations, 2017, it falls within the "Ledger Account D" balance in the Statement of Changes in Equity, it is not in reality, part of the shareholders' equity, and is actually in the nature of a non-distributable reserve payable only to the participants.

In the absence of any prescribed treatment for the same in the Insurance Accounting Regulations, 2017, we have, as well as other listed life insurance companies have, made a disclosure in the accounts of the fact that included in the Ledger Account D balance, is the surplus arising in the Participants' Takaful Fund of the Individual Life Family Takaful Fund, which, under the Waqf Deed of the Fund, is distributable only to the participants of the fund based on the advice of the Appointed Actuary and the Shariah Advisor, and is not available for distribution to the shareholders. We are however, of the view that a disclosure to this effect is not sufficient, and the current prescribed accounting treatment needs to be rectified in the Insurance Accounting Regulations, 2017, to reflect the same as a liability, and not as part of the shareholders' equity. We have also discussed the same with our external auditors, who concur with our view. We request the Commission to kindly issue necessary clarification in the matter and amend the Insurance Accounting Regulations, 2017 accordingly.

We would appreciate if the opinion of the ICAP is provided on the matter deliberated hereinabove.

Opinion:

The Board observes that a conventional life insurance company registered under the Insurance Ordinance 2000 (Insurance Ordinance) may conduct takaful business after applying for and obtaining authorization as a "Window Takaful Operator" under Rule 6 of the Takaful Rules 2012.

Takaful Rules 2012 define Window takaful operator as under:

> "*Means a registered insurer authorised under these rules to carry on Takaful business as window operations in addition to conventional insurance business.*"

With regard to the applicability of the requirements of the Insurance Ordinance, Rule 4(3) of the Takaful Rules 2012 states:

> *"All provisions of the Ordinance and insurance rules pertaining to life insurance business shall be deemed to apply to Family Takaful business and all provisions of the Ordinance and insurance rules pertaining to non-life insurance business shall be deemed to apply to General Takaful business."*

The financial reporting related provisions contained in Rule 29 of the Takaful Rules 2012 state:

> *"(1) The Commission shall issue accounting regulations for accounting treatments for Takaful operations of the Operators.*
>
> *(2) For the purposes of sub-sections (1) and (2) of section 46 of the Ordinance the statements shall be furnished in the form as may be specified by the Commission."*

Amongst the conditions applicable to Window Takaful Operator, Rule 11(b) of the Takaful Rules 2012 requires a separate reporting of assets, liabilities, revenues and expenses for each segment of conventional and takaful business. Further, under Rule 11(c) of the Takaful Rules 2012, the SECP may also specify other requirements relating to financial reporting by Window Takaful Operator. In general, the financial reporting framework and underlying requirements applicable to conventional life insurance business are also applicable to the window takaful operations.

The financial reporting framework comprises of such International Financial Reporting Standards (IFRS) as are notified under the Companies Act 2017 along with provisions and directives issued thereunder, the Insurance Ordinance, Insurance Rules 2017, Insurance Accounting Regulations 2017 and Takaful Rules 2012.

The life insurance companies (under section 14 of the Insurance Ordinance) are required to maintain separate statutory funds in respect of assets, liabilities, equity and profit or loss attributable to life insurance business. Further, Rule 10(1) of the Takaful Rules, 2012 requires establishment of one or more statutory funds exclusively for takaful business.

In accordance with the Insurance Ordinance the ledger accounts A, B, C and D represent the sub-components of a statutory fund, section 22 of the Insurance Ordinance explains these as follows:

- Ledger account A represents retained earnings on participating business attributable to participating policyholders;
- Ledger account B represents retained earnings on participating business attributable to shareholders but not distributable;
- Ledger account C represents retained earnings on participating business distributable to shareholders; and
- Ledger account D represents retained earnings on business other than participating business.

The Board further notes that the financial reporting requirements under the Insurance Ordinance are specified in section 46 and section 52.

Section 46 requires preparation of the following statements as annual statutory accounts of the life insurance company separately for each statutory fund:

- a statement of assets and liabilities for each statutory fund operated by the life insurer and the shareholders' fund;
- a statement of profits and losses for the shareholders' fund;
- a statement of cash flows for each statutory fund operated by the life insurer and the shareholders' fund;

- a revenue account for each statutory fund operated by the life insurer;
- a statement of premiums for each statutory fund operated by the life insurer;
- a statement of claims for each statutory fund operated by the life insurer;
- a statement of expenses for each statutory fund operated by the life insurer;
- a statement of investment income for each statutory fund operated by the life insurer;
- such other statements as may be prescribed by the Federal Government.

The formats for the preparation of the above annual statutory accounts were previously provided under the SEC (Insurance) Rules 2002. However, these have now been repealed by and included in the Insurance Rules 2017.

Section 52 of the Insurance Ordinance empowers SECP to prescribe the formats of the financial statements required to be prepared under the repealed Companies Ordinance 1984 (Now Companies Act 2017). Until 2017, the annual statutory accounts prepared and filed under section 46 of the Insurance Ordinance 2000 were deemed to satisfy the financial reporting requirements of both the repealed Companies Ordinance and the Insurance Ordinance. However, the Insurance Rules 2017 and the Insurance Accounting Regulations 2017 introduced the requirement to prepare and file the "Published Financial Statements" to comply with the financial reporting requirements of the Companies Act, in addition to preparation and filing of annual statutory accounts under Insurance Ordinance.

The Board recognises that the formats for the published financial statements prescribed under the Insurance Rules 2017 require the companies to prepare the published financial statements as one unit/basket rather than the approach to prepare separate statements for shareholders' fund and statutory funds as required under section 46 of the Insurance Ordinance.

Accordingly, the Insurance Accounting Regulations 2017 prescribed the sub-components of the statutory funds (i.e. Ledger accounts A, B, C and D) to be classified either as equity or liability in the published financial statements as the columnar presentation of the statements in respect of each statutory fund was not required.

The Board notes that the regulation 6 of the Insurance Accounting Regulations 2017 requires that in the published financial statements, the balances in the:

a) Ledger accounts A and B shall be included in the insurance liabilities in the statement of financial position.

b) Ledger accounts C and D shall be included as a part of the shareholders' equity.

As mentioned earlier, rule 10(1)(d) of the Takaful Rules 2012 requires establishment of one or more statutory funds exclusively for takaful business. Further, under rule 10(1)(d) an operator carrying out family takaful business is required to divide each statutory fund set up for takaful business into sub-funds, namely:

- Participant Takaful Funds;
- Operator Sub-Fund; and
- Participant Investment Funds (in case of investment contracts)

These sub-funds in the context of a family takaful business have been defined in the Takaful Rules, 2012 as follows:

- Participant Takaful Fund ((PTF): In the case of a Family Takaful Operator a sub-fund of a statutory fund into which the participant's risk related contributions are paid and from which risk related benefits are paid out.

- Operator Sub-Fund (OF): Means a sub-fund of a statutory fund set up by a Family Takaful Operator in which all takaful operator fees shall be credited and from which all expenses relating to the Statutory Fund which are not charged to any Participant Takaful Fund or Participant Investment Fund shall be debited.

- Participant Investment Fund (PIF): Means a separate group of assets forming a sub-fund of a statutory fund of a Family Takaful Operator which is to be used as a basis for determination of the benefits payable under a Family Takaful contract.

In context of discussion under the enquiry, the Board also considers it relevant to mention the definition "participant" and "Takaful Contract" as contained in the Takaful Rules 2012:

"Participant means a person who participates in a Takaful scheme and to whom a Takaful Contract is issued.

"Takaful Contract means any contract of Family Takaful or General Takaful.

The Board observes that the ledger accounts A, B, C and D under the Insurance Ordinance represent the sub-components of a statutory fund, however, their origination and prescribed accounting is based on the conventional insurance business.

Further, the Board notes that rule 19 of the Takaful Rules, 2012 outlines the requirements relating to the utilization (i.e. receipt, payment and reserves) of the PTF.

The Board notes that the said rule prescribes distribution of surplus to the participants, however it does not include any allowance whereby, the surplus arising in the PTF can be attributed to the shareholders of a life insurance company (i.e. become part of equity).

Rule 19 is reproduced hereunder:

1) *"The receipts of a Participant Takaful Fund shall consist of the following, namely:-*

   a) *Contributions from Participants (in the case of a Family Takaful Operator, net of any amounts credited directly to Participant Investment Funds or the Operator sub-fund);*

   b) *share of claims from Re-Takaful operators;*

   c) *investment income generated by the investment of funds retained in the Participant Takaful Fund;*

2) *The receipts of a Participant Takaful Fund shall consist of the following, namely:-*

   a) *Contributions from Participants (in the case of a Family Takaful Operator, net of any amounts credited directly to Participant Investment Funds or the Operator sub-fund);*

   b) *share of claims from Re-Takaful operators;*

c) *investment income generated by the investment of funds retained in the Participant Takaful Fund;*

d) *in the case of General Takaful, salvages and recoveries;*

e) *qard-e-hasna;*

f) *rebate/commission from re-Takaful operators/reinsurers;*

g) *share of surplus from Re-Takaful operators; and*

h) *any donation made by the shareholders of the Operator.*

3) *The payments from a Participant Takaful Fund shall consist of the following, namely:-*

a) *any third party costs directly associated with underwriting (specifically medical examination, pre-cover inspection/surveys, costs of installing tracking systems or any consulting costs related with assessing or reducing the risks being covered), if it has been earlier credited to the Participant Takaful Fund;*

b) *claims paid related to risks covered under the Participant Takaful Fund and expenses directly related to settlement of claims such as surveyors' and investigators' fees, etc;*

c) *Re-Takaful and reinsurance contributions;*

d) *Takaful operator's fees if it has been credited to the Participant Takaful Fund;*

e) *share of investment profits of the mudarib or wakala fees for investment management or any other combination thereof approved by the Appointed actuary in the case of Family Takaful operator and Shariah Advisor of the General Takaful Operator;*

f) *surplus distributed to Participants;*

g) *refund of any Contribution due to Participants; and*

h) *return of qard-e-hasna to the Operator fund / Operator sub-fund*

(Emphasis is ours)

Additionally, the Waqf Deed of the PTF also prohibits the distribution of PTF surplus to the shareholders of the life insurance company.

In terms of the financial reporting, financial statements portray the financial effects of transactions and other events by grouping them into broad classes, the elements of financial statements. Elements are the building blocks from which financial statements are constructed

The Board refers to the *Conceptual Framework for Financial Reporting*, wherein, the elements of the financial statements have been defined.

Related definitions of elements are as follows:

- Liability is defined as a *"present obligation of the entity arising from the past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits"*.

- The definition of equity is derived from the definition of assets and liabilities, and it is "*the residual interest in the assets of the entity after deducting all its liabilities*".

- Income is defined as *"an increase in economic benefits during the period in the form of inflows or enhancements of assets or decreases in liabilities that result in equity, other than those related to contributions from equity participants."*

- Expenses are defined as, "*Expenses are decreases in economic benefits during the period in the form of outflows or depletions of assets or increases in liabilities that result in decrease in equity, other than those related to distributions to equity participants."*

The above definitions of income and expense exclude capital transactions with equity participants. Accordingly, such transactions are recognised in equity.

The Board notes that Takaful Rules do not contain definition of the "Participant liabilities/ Participant related liabilities", however, Board considers it pertinent to refer to the definition of "Policyholder liability" provided in the Insurance Ordinance:

> *"Policyholder liability, in relation to life insurance, means:*
>
> *a) a liability that has arisen under a policy of life insurance; or*
>
> *b) a liability that, subject to the terms and conditions of a policy, will arise on the happening of an event, or at a time, specified in the policy."*

Further the definitions of "Policy" and Policyholder" are reproduced below for reference purposes:

> "*Policy means a contract of insurance"*
>
> *"Policy holder means the person to whom a policy is issued or, in the case of a policy of life insurance, the person to whom the whole of the interest of the policy holder in the policy is assigned once and for all, but does not include an assignee thereof whose interest in the policy is defeasible or is for the time being subject to any condition."*

Further, the Board notes that the waqf deed contains dissolution related requirements of PTF. Under the waqf deed in case of dissolution, surplus of PTF after paying off the liabilities and Qard-e-Hasna would be distributed to participants, and importantly shareholders of Window Takaful Operator would not be entitled to any amount of the surplus.

The Board emphasizes that the participants' in a window takaful operations are not the equity holders/ shareholders of the window takaful operator. The participants in takaful business enter into a contract with the window takaful operator, and they in substance are similar to the conventional insurance policyholders.

As outlined in the rule 19 of the Takaful Rules 2012, surplus of PTF is distributable to the participants. Conversely, there is no provision which attributes such surplus to the shareholders of a window takaful operator.

Moreover, in consideration of the above definitions of liability and equity (contained in the *Conceptual Framework*) and definitions of participant and policy holder liability (contained in Takaful Rules 2012 and Insurance Ordinance, respectively), indicate that the classification of surplus of PTF as part of shareholders' equity is not appropriate and reflective of the substance of such balance.

The financial accounting and reporting requirements contained in the Insurance Ordinance and related Insurance Accounting Rules 2017, Insurance Accounting Regulations 2017 and Takaful Rules 2012, currently do not contain specific guidance on treatment and presentation of surplus retained in PTF in the published financial statements of window takaful operator.

The Board suggests that SECP, in consideration of above discussion, consider issuing a clarification based on the accounting substance of the surplus retained in PTF. The requisite clarification would outline that the surplus retained in PTF be classified as insurance liability in the published financial statements whereas the balance of ledger account D would represent the amount attributable to shareholders only, and classified as equity in the published financial statements of window takaful operator.

Based on the above, the Board concludes that the:

a) Participants of window takaful operator are similar to the policyholders of conventional insurance. Accordingly, participants are not shareholders of window takaful operator.

b) Participants are entitled to the surplus retained in the PTF in accordance with the provisions of the Takaful Rules 2012, Waqf Deed and Takaful contract. In contrast, shareholders of window takaful operator are not entitled to the surplus of PTF.

c) Ledger account D contains retained earnings of other than participating business that are attributable to the shareholders of window takaful operator. Inclusion of surplus retained in PTF in Ledger Account D, and its consequent presentation in the published financial statements under shareholders' equity is not in accordance with the accounting substance of the PTF and its surplus.

d) The Insurance Ordinance 2000 and related Insurance Accounting Rules 2017, Insurance Accounting Regulations 2017 and Takaful Rules 2012 do not provide specific guidance on the accounting and presentation of the surplus retained in PTF in the published financial statements of window takaful operator. SECP in consideration of this is recommended to issue clarification that the surplus retained in PTF be classified as insurance liability in the published financial statements whereas the balance of ledger account D would represent the amount attributable to shareholders only, and classified as equity in the published financial statements.

(January 31, 2019)

1.6 Accounting treatment of cost incurred on bridge construction under 'Design, Finance, Build, Operate and Transfer' (DFBOT) basis

Enquiry:

A company has entered into a Concession Arrangement (the Agreement) with the Provincial Government for development of a bridge over a river connecting highways (the infrastructure) on **Design, Finance, Build, Operate and Transfer (DFBOT)** basis.

The Concession Agreement is for the term of 25 years according to which the company is responsible to build the infrastructure and operate and maintain the same and transfer the infrastructure to the government at the end of the term of the Agreement. In consideration of referred responsibilities, the company is entitled under the Agreement to receive guaranteed annuity payments from respective government and not in the form of toll collection.

The Project Site whereupon the Bridge (the Infrastructure) is developed is provided by Government under lease that shall expire on the expiry of the Concession Agreement. Moreover, the agreement also provides that the lease in respect of the Project Site will terminate automatically on the Transfer Date without need for any action to be taken by the relevant government to terminate the lease.

However, no legal document in the shape of lease of land is created till date and only legal document is a letter whereby possession was handed over to the company. The lease of land or possession of premises was handed over to the company for specific purpose and specific time limit. The Company was legally debarred from doing any other act on premises or utilizing said premises for any purpose other than construction of infrastructure. Whereas, the company is to maintain the title and interest in the Infrastructure and shall transfer the same to the government at the end of the term of the Concession Agreement.

Your guidance is requested on:

- Whether or not the company can reflect the cost incurred in completion of this project as its fixed asset for period of 25 years? More specifically can it be entitled to claim depreciation on this tangible asset over period of 25 years? Specifically considering IAS 11, IAS 16 and suspension of IFRIC 12?

- If not, can the cost incurred in completion of this project be treated as Receivable from respective provincial government, to be amortized over period of time with recovery of sum.

- Whether or not suspension of IFRIC 12 'Service Concession Arrangements' by the SECP has any bearing on this issue to reflect the cost of building bridge as 'Property, Plant and Equipment' of the company.

- In the view of current exemption from IFRIC 12, the Technical Committee of the Institute may kindly guide appropriate accounting treatment/disclosure of cost incurred in construction of infrastructure project.

Opinion:

The Board notes that the enquirer has analyzed the enquired arrangement pertaining to agreement with a provincial government for construction of a bridge by an entity under Design, Finance, Build, Operate and Transfer (DFBOT) basis, under IAS 11 *Construction Contracts,* IAS 16 *Property, Plant and Equipment* and IFRIC 12 *Service Concession Arrangements*.

The enquirer has concluded that the application of IFRIC 12 is currently suspended by SECP through SRO 24(1)/2012 dated January 16, 2012. Had IFRIC 12 not been suspended the accounting treatment of cost of infrastructure and other components of the arrangement would have been governed under IFRIC 12. The Board in view of above statement of the enquirer understands that the enquirer has determined and concluded that the arrangement falls under the scope of IFRIC 12.

The Board notes that the Companies Act 2017 outlines the financial reporting framework for companies. Section 225(1) of the Companies Act 2017 states:

> *"The financial statements shall give a true and fair view of the state of affairs of the company, comply with the financial reporting standards notified by the Commission and shall be prepared in accordance with the requirements contained in the Third Schedule for different class or classes of companies."*

The 'Introduction' of IFRS Standards explains that:

> *"IFRS Standards are mandatory pronouncements and comprise:*
>
> *a) IFRS Standards*
>
> *b) IAS Standards; and*
>
> *c) Interpretations developed by the IFRS Interpretations Committee or its predecessor body, the Standing Interpretations Committee."*

The Board would like to highlight that IFRIC interpretations are developed by the IFRS Interpretations Committee ((the Committee) and are issued after approval by the International Accounting Standards Board (IASB).

The Committee is the interpretative body of IASB and is established to help IASB in improving financial reporting through timely identification, discussion and resolution of financial reporting issues within the IFRS framework. The Committee develops authoritative interpretations of existing IFRSs and to achieve full compliance with the IFRSs, an entity must comply with all aspects of IFRSs including IFRICs. Accordingly, the IFRIC interpretations are part of accounting and reporting standards notified under the Companies Act 2017 by SECP.

The Board also notes that SECP is empowered under section 225(3) of the Companies Act 2017 to grant exemption to any company or class of companies from the requirements of approved accounting standards as applicable in Pakistan. Under the same powers, the SECP has granted exemptions in past from the requirements of various IFRSs and related IFRICs.

The SECP vide SRO 24(I)/2012 dated January 16, 2012 granted waiver to all the companies from the requirements of IFRIC 12. The waiver is granted under section 225(3) of the Companies Act, 2017 which states:

> *"The Commission shall have power from time to time to grant exemption to any company or any class of companies if it is in the public interest so to do, from compliance with all or any of the requirements of the relevant Schedule."*

The determination of complete implications of the exemption/waiver granted under section 225(3) of the Companies Act, 2017 is a matter of legal interpretation. However, the Board understands that waiver from the requirements of IFRIC 12 granted to all companies under section 223(5) of the Companies Act 2017, does not restrict a company from voluntarily applying IFRIC 12 when it intends to do so.

The Board acknowledges that SECP has granted waiver from application of IFRIC 12, however, it emphasizes that the fair presentation of the financial statements is one of the core underlying objective of the IFRS:

Paragraph 15 of IAS 1 states that:

> *"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."*
>
> (Emphasis is ours)

IAS 1 also explains that "*In virtually all circumstances an entity achieves fair presentation by compliance with applicable IFRSs".*

Paragraphs 19 and 20 of IAS 1 provide guidance in the circumstances where the departure from IFRS is either required or is not otherwise prohibited by the relevant regulatory framework. These paragraphs require that, in extremely rare circumstances, in which management concludes that compliance with a requirement in IFRS would be so misleading that it would conflict with the objective of financial statements as set out in the framework, a company shall depart from that requirement and provide additional disclosures about such departure if the relevant regulatory framework requires or otherwise does not prohibit such a departure. However, it is to be noted that the circumstances requiring departure from IFRS would be extremely rare.

Further, paragraph 24 of IAS 1 explains that an item of information would conflict with the objective of financial statements when it does not present faithfully the transactions, other events and conditions that it either purports to represent or could reasonably be expected to represent and, consequently it would be likely to influence economic decisions made by users of financial statements.

In consideration of above, the Board believes that the fair presentation and faithful representation of the enquired arrangement would be under the IFRIC 12. Accordingly, the Board suggests that the entity applies IFRIC 12 in accounting for the subject service concession arrangement. Further, the entity should also comply with all other requirements of IFRS Standards related to the arrangement, though SECP might have granted exemptions from such IFRS Standards (e.g. IAS 21 exemption of capitalization of foreign exchanges losses, IFRS 9 exemption of embedded derivative accounting etc.)

In view of the above, the Board concludes that:

a) Based on the facts and circumstances mentioned in the enquiry the enquirer prepares statutory financial statements in accordance with accounting and reporting standards as applicable in Pakistan (which include International Financial Reporting Standards notified by SECP and the requirements of the Companies Act 2017). Further, the enquirer has determined that agreement with a provincial government for construction of a bridge by an entity under DFBOT basis falls under the scope of IFRIC 12 *Service Concession Arrangements*.

b) The IFRIC interpretations are approved by the International Accounting Standards Board (IASB). These are authoritative interpretations that provide clarification on the application of issued IFRS, hence are part of IFRS Standards. Accordingly, the

IFRIC interpretations are part of accounting and reporting standards. These accounting and reporting standards are notified by Securities and Exchange Commission of Pakistan (SECP) under the Companies Act 2017.

c) SECP has granted waiver to all companies from the application of IFRIC 12. In relation to the IFRS specified accounting requirements and their application, the Institute and the Board support application of IFRS Standards. An entity achieves fair presentation by compliance with applicable IFRS Standards. The accounting of the enquired arrangement under IFRIC 12 would present fairly the financial position, financial performance and cash flows of the entity.

   The Board understands that waiver from the requirements of IFRIC 12 granted to all companies under section 223(5) of the Companies Act 2017, should not restrict a company from voluntarily applying IFRIC 12 when it intends to do so.

d) In view of above, the entity should voluntarily apply IFRIC 12 to the enquired service concession arrangement. Further, the entity should also comply with all other requirements of IFRS Standards related to the arrangement, though SECP might have granted exemptions from such IFRS Standards.

(March 19, 2019)

1.7 Guidance on revenue recognition for a software distributor

Enquiry:

A company acts as a distributor of software of international vendors like Microsoft (MS), IBM and Oracle under distribution agreement with these parties. The principal responsibilities of the distributor include:

- marketing and coordinating with end consumer or Re-seller, (if any)
- collection of payment from end consumer
- remitting funds to foreign vendors after deduction of local taxes.

The examples of two types of licenses generally distributed are:

- Time bound license by agreement or subscription based license
- Open value license; Life time license with limited time support from MS

The right to accept or reject a customer is with foreign software vendors. Similarly, the distributor can also be changed for any arrangement at the request of end customer. The total margin of distributor is generally fixed percentage comprising both specific front end from customers and remaining percent back end from vendor in shape of rebate. The distributor is also subject to periodical audit of its accounts by foreign software vendors.

Presently distributor is also levying GST on the invoice value under Sales Tax Act, 1990; treating the transaction as sale of goods. The orders placed by distributor for the licenses with international software vendors specifically contain name of the end user. Further, such orders are also reconfirmed by international software vendors directly through email to end consumer.

The licenses are exclusively issued by these vendors only in the name of end consumer; and presently based on specific code given the end consumer is able to download software directly from vendor's site or able to gain access to cloud based services. The distributor neither owns risk and reward associated with such license or access given. Nor distributor can dispose of such license at its own will to anybody as such licenses are exclusively issued to the specific end consumer. Even it cannot use it for its own purposes.

Even the end consumer only gets the 'right to use' and not the ownership and title over the software. It cannot make copies of it, neither distribute it further nor sell it. The distributor itself issues invoices to end consumers reflecting the transaction as 'sale of good' and resultantly tax is also deducted by end consumer u/s 153 of the Income Tax Ordinance, 2001 from payment to distributor/reseller u/s 153(1)(a) as supply of goods. The distributor itself deducts tax from payments to these foreign vendors u/s 152(1) of the Income Tax Ordinance as royalty payment.

Whether based on the above stated facts and practice of the transactions; it can be reflected/disclosed in financial statements as 'sale of goods' or it should be merely be disclosed in financial statements of distributor as service fee or agency commission to the extent of its margin.

Opinion:

The Board would like emphasize that the principal vs. agent analysis requires the use of significant judgment under the new revenue standard i.e. IFRS 15 as the nature of entity's promise under the contract may not always be readily apparent. The assessment in such cases should be done considering the specific facts and circumstances in each case including contractual terms.

The Board notes that core principle of the IFRS 15 *Revenue from Contracts with Customers* is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

To achieve that core principle, an entity should apply the following steps:

- Identify the contract(s) with a customer.
- Identify the performance obligations in the contract.
- Determine the transaction price.
- Allocate the transaction price to the performance obligations in the contract.
- Recognize revenue when (or as) the entity satisfies a performance obligation.

The Board understands that in relation to the enquiry the fundamental point is determination of role of the enquirer i.e. principal or agent. A company is acting as a principal when the nature of its promise (i.e. performance obligation) is to provide the goods or services itself. A company is acting as an agent when the nature of its promise is to arrange for goods or services to be provided by another party.

The Board notes that when a party other than the entity is involved in providing goods or services to a customer, IFRS 15 requires the entity to determine whether it is:

a) the principal in the transaction (recognising as revenue the transaction price allocated to the entity's performance obligation of providing the specified goods or services to the customer); or

b) the agent (recognising as revenue the fee or commission for arranging for the other party to provide goods or services to the customer).

Paragraphs B34–B38 of IFRS 15 include guidance to help an entity make that determination. Paragraph B34 of IFRS 15 sets out the principle for determining whether an entity is a principal or an agent, as follows:

> *"When another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to **provide** the specified goods or services itself (i.e. the entity is a principal) or to **arrange** for the other party to provide those goods or services (i.e. the entity is an agent)".*
>
> [Emphasis added]

The Board would like to highlight that identifying and understanding a company's promise (i.e. its performance obligation), and determining if the company controls these goods or services before their transfer to the customer, is fundamental to determining if the company is the principal or an agent.

The application guidance of IFRS 15 (paragraph B34A) sets out the following two step process that a company would apply in determining it is a principal or agent in a contract with customer:

- **identify the specified goods or services to be provided** to the customer (which, for example, could be a right to a good or service to be provided by another party); and

- **assess whether it controls each specified good or service** before that good or service is transferred to the customer.

The Board notes that a company controls an asset if it has the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. This includes the ability to prevent others from directing the use or obtaining the benefits of the asset.

Paragraphs B35–B37 of IFRS 15 then explain that (a) an entity determines whether it provides, or arranges for another party to provide, the goods or services by assessing whether it controls those goods or services before transfer; and (b) provides some indicators to help make that control assessment.

Paragraph B35 of IFRS 15 explains that an entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. An entity that is a principal in a contract may satisfy its performance obligation by providing the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

Paragraphs B35 and B36 are reproduced below:

> *"**An entity is a principal** if the entity controls a promised good or service before the entity transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if the entity obtains legal title of a product only momentarily before legal title is transferred to a customer. An entity that is a principal in a contract may satisfy a performance obligation by itself or it may engage another party (for example, a subcontractor) to satisfy some or all of a performance obligation on its behalf. When an entity that is a principal satisfies a performance obligation, the entity recognises revenue in the gross amount of consideration to which it expects to be entitled in exchange for those goods or services transferred."*
>
> *"**An entity is an agent** if the entity's performance obligation is to arrange for the provision of goods or services by another party. When an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party."*

Paragraph BC380 states that a principal controls the goods or services before they are transferred to a customer. Consequently, the principal's performance obligation is to transfer those goods or services to the customer. In contrast, an agent does not control the goods or services before they are transferred to a customer. The agent merely facilitates the sale of goods or services between a principal and the customer. Consequently, an agent's performance obligation is to arrange for another party to provide the goods or services to the customer.

Paragraph B35A of IFRS 15 outlines that when another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

- a good or another asset from the other party that it then transfers to the customer.
- a right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.
- a good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer.

Based on the facts and circumstances mentioned in the enquiry, the Board notes that:

- the orders are placed by the distributor in the name of end consumer and confirmation of the order is sent by the foreign vendor directly to the end consumer;

- the licenses are exclusively issued by the foreign vendor in the name of consumer who directly obtains the software from the foreign vendor;

- under the distribution agreement, the distributor does not have a right to the software to be provided to the end consumer on its behalf by the foreign vendor. Neither, do the distributor obtain the software from the foreign vendor as an input to be combined with its own goods and services, and then sold to the end consumer.

Therefore, in terms of paragraph B35A above, the Board understands that the condition of distributor obtaining control of the software before it is sold to the end consumer does not appear to be satisfied.

The Board notes that IFRS 15 guidance (paragraph B37) includes indicators to help an entity determine whether it controls the goods or services before transferring them and thus whether the company is a principal or agent. These indicators support, but do not override, the control principle.

a) **The entity is primarily responsible for fulfilling the promise to provide the specified good or service**.

   This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.

   Based on the facts and circumstances mentioned in the enquiry, the Board understands that the distributor does not appear to be primarily responsible for delivering the software to the end consumer, as the order is placed in the name of end consumer and delivery of software is also made directly to it.

b) **The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return)**.

   For example, if the entity obtains, or commits itself to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.

   Based on the facts and circumstances mentioned in the enquiry, the Board understands that the distributor does not appear to have any inventory risk as the software is delivered directly by the foreign vendor to the end consumer.

c) **The entity has discretion in establishing the price for the specified good or service.**

Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

Based on the facts and circumstances mentioned in the enquiry, the Board understands that the distributor does not appear to have any discretion in establishing the price of software delivered to the end consumer by the foreign vendor.

The Board understands that the indicators do not override the assessment of control and should not be viewed in isolation as these do not constitute a separate or additional evaluation. Further, there is no specific hierarchy for the indicators, and depending on the facts and circumstances one or more indicators may be more relevant to the specific contract.

Paragraph BC382 explains that indicators in paragraph B37 of IFRS 15 have been included to help an entity determine whether the entity controls the goods or services before transferring them and thus whether the entity is a principal or an agent. The indicators are not intended to be factors or criteria that directly give an entity control rather these have been included to be helpful because, if an indicator or indicators exist, then it is likely that the entity also has control of the good or service before transfer.

Accordingly, the Board understands that determination of whether an entity is acting as a principal or an agent under a given contract should be based on the ‘Control Principle’ as envisaged under IFRS 15. The principle requires an entity to determine, based on all the relevant facts and circumstances including the contractual terms, whether the entity controls the specified goods or services before these are transferred to the end customer.

Based on the facts and circumstances mentioned in the enquiry and assessments done in paragraph 11 and 12 above, the Board understands that the distributor in the enquired scenario does not appear to control the software before it is transferred to the end consumer. Accordingly, the Board understands that the distributor in the context of enquired scenario is an agent under the principles outlined in IFRS 15.

Based on the above, the Board concludes that the:

a) The determination of whether an entity is acting as a principal or an agent under a given contract should be based on the ‘Control Principle’ as envisaged under IFRS 15. The principle requires an entity to determine, based on all the relevant facts and circumstances including the contractual terms, whether the entity controls the specified goods or services before these are transferred to the end customer. Paragraph B34-B38 of IFRS 15 provide guidance to assist an entity in making the significant judgements about the Control Principle.

b) Based on the facts and circumstances mentioned in the enquiry and assessments done in Appendix A, the distributor in the enquired scenario does not appear to control the software before it is transferred to the end consumer. Accordingly, the Board understands that the distributor in the context of enquired scenario is an agent under the principles outlined in IFRS 15.

c) As an agent, the distributor in the enquired scenario should recognize net amount of consideration after the foreign vendor is compensated for its goods (i.e. agency fee or commission) as its revenue.

The Board would like to emphasize that its assessment is strictly based on the facts and circumstances mentioned in the enquiry. Therefore, the Board is not aware of and has not considered any other facts and circumstances that might have an effect on the assessment of distributor's role as an agent or principal in the context of enquired scenario. Further, the Board's analysis and conclusion is related to accounting aspects of the enquired scenario in the light of requirements of accounting and reporting standards as applicable in Pakistan. Therefore, the Board has not considered any implications arising under other laws and regulations such as Income Tax Ordinance, 2001 and Sales Tax Act, 1990.

(March 19, 2019)

1.8 Deferred tax in case of Final Tax Regime (FTR)

Enquiry:

- In one of the selected opinions published by the Institute relating to IAS 12 'Income Taxes', it has been stated that deferred tax accounting does not apply to those companies whose entire income is subject to deduction of tax at source that is taken as a final tax liability.

- According to IAS 12, temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. IAS 12 requires the recognition of deferred tax liability for all taxable temporary differences, and similarly deferred tax asset shall be recognized for all deductible temporary differences to the extent of availability future taxable profits.

- In the purview of that, we have encountered a situation which delineates the necessity of deferred taxation in case of delayed or advance receipts, even when the entity's entire income is subject to final tax liability. Following illustration is provided to explain the issue:

Scenario 01 (Delayed Receipts)

- Results as per tax computation & selected opinion

Particulars	Year 1	Year 2
Revenue	5,000	5,000
Receipts	-	**10,000**
Tax on receipts (7%) - FTR	**-**	**700**

- Results as per tax computation & IAS - 12

Particulars	Year 1	Year 2
Revenue	5,000	5,000
Receipts	-	**10,000**
Tax on receipts (7%) - FTR	-	700
Deferred tax on taxable temporary difference arising on receivable	350	(350)
	350	**350**

Scenario 02 (Advance Receipts)

- Results as per tax computation & selected opinion

Particulars	Year 1	Year 2
Revenue	5,000	5,000
Receipts	10,000	**-**
Tax on receipts (7%) - FTR	**700**	**-**

- Results as per tax computation & IAS - 12

Particulars	Year 1	Year 2
Revenue	5,000	5,000
Receipts	**10,000**	**-**
Tax on receipts (7%) - FTR	700	-
Deferred tax on deductible temporary difference arising on advance receipt	(350)	350
	350	**350**

- First scenario is depicting the fact of origination of temporary differences at year 1, which are getting reversed. Similarly, second scenario is also instigating the need of deferred taxation as temporary differences are evident in year 1 and getting subsequently reversed in year 2.

Based on the above, the opinion of the institute is requested in order to get clarification in respect of aforementioned subject matter.

Opinion:

The Board notes that paragraph 2.1 of TR 27 – IAS 12, "Income Taxes" states:

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

The Board understands that the rationale for non-existence of temporary differences in respect of income covered under final tax regime is explained in a selected opinion issued in May 2008 by the Technical Advisory Committee (TAC) of the Institute in relation to accounting treatment of final tax on import of goods under section 148 of the Income Tax Ordinance (ITO), 2001. Section 148(7) of the ITO, 2001 in relation of final tax on import of goods states:

> *"The tax collected under this section shall be a final tax on the income of the importer arising from imports."*

Similarly, Section 153(3) in relation to final tax on payments for goods and contracts states:

> *"The tax deductible under clause (a) and (c) of sub-section (1) and under sub-section (2) of this section, on the income of a resident person shall be final tax."*

The Board notes that the selected opinion issued by TAC in May 2008 states (relevant portion reproduced only):

> *"Hence it is clear that the final tax on imports is actually on the income of the importer arising from imports such that the total amount of tax is a percentage of the import value. In other words, it may be seen as a variable tax rate being applicable on the income of the importer from imports that equates the tax on income to a certain percentage of assessed value.*
>
> *ITO 2001 gives the timing of the payment of tax on income from imports. However, it is established that whatever be the timing, the tax is on the income of the importer from imports and hence, till the time the income does not so arise, it merely is a prepayment of tax in relation to such income albeit being final is not refundable but entails future economic benefit that will flow to the tax payer as a direct consequence of import stage taxation in the period when the imported goods are sold."*
>
> *"Further, the Committee is of the opinion that the practice of treating final tax as a "period cost" in isolation without undertaking a matching process to determine whether the goods on the value whereof such income tax has been imposed, have been sold or carried over to the next accounting period as inventory negates the very foundation of tax accounting that income taxes are considered to be an expense incurred by the company as a consequence of income earned and therefore, are accrued in the same period as the income to which they relate."*

The Board notes that paragraph 17 of IAS 12 explains that some temporary differences arise when income or expense is included in accounting profit in one period but is included in taxable profit in a different period. Such temporary differences are often described as timing differences.

The Board understands that TAC of the Institute in the aforementioned selected opinion has clarified that there is no temporary difference where income of a taxpayer is subject to final tax because there is no timing difference between inclusion of related income in the taxable and accounting profit. The final tax represents a variable tax being applicable on the income derived from the activity subject to final taxation and the deduction of tax at source only represents timing of payment of tax, not it chargeability. The opinion of TAC further stresses that the concept of matching taxes with the corresponding income is also required by paragraph 12 of IAS 12, which states:

> *"Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset."*

On the basis of above discussion, the Board understands that:

- There is no deferred tax implication in both of the scenarios provided in the enquiry as the entire income is subject to final taxation and as such, no temporary differences arise;

- The current tax expense and corresponding liability relating to final taxes should be recognized in profit or loss to the extent that the related income/revenue has been recognized in the year.

- In the scenario 1, current tax expense and liability of Rs. 350 on the revenue of Rs. 5,000 should be recognized in year 1. In year 2, the total tax payments of Rs. 700 comprise settlement of current tax liability of year 1 (i.e. Rs. 350) and payment of current tax expense for year 2 (i.e. Rs. 350).

- In the scenario 2, the total tax payments of Rs. 700 in year 1 comprises payment of current tax liability of year 1 (i.e. Rs. 350) on revenue recognition of Rs. 5000 and prepayment of current tax expense for year 2 (i.e. Rs. 350) on revenue received in advance amounting Rs. 5000. In the year 2, current tax expense of Rs. 350 shall be recognized with the derecognition of prepaid current tax of Rs. 350 brought forward from year 1.

(March 22, 2019)

1.9 Clarification of disclosure requirements for disposal of fixed assets under the Companies Act, 2017

Enquiry:

I am writing this to have clarification on a matter of disclosure specified under 4th and 5th schedule of the Companies Act 2017. The clause 15 and 10 of part II of 4th and 5th schedule respectively states:

> *In the case of sale of fixed assets, if the aggregate book value of assets exceeds five hundred thousand rupees, following particulars of each asset shall be disclosed:*
>
> *(i) cost or revalued amount, as the case may be;*
>
> *(ii) the book value;*
>
> *(iii)the sale price and the mode of disposal (e.g. by tender or negotiation);*
>
> *(iv) the particulars of the purchaser;*
>
> *(v) gain or loss; and*
>
> *(vi) relationship, if any of purchaser with Company or any of its directors.*

The above disclosure requires a company to disclose 'all' the disposals during the year in case the aggregate book value of all disposals exceeds Rs. 500,000. This would mean that assets with book values of nil or very trivial would also require disclosure in the financial statement, further there would be a list of very small fixed assets which would also come under such disclosure.

My understanding is that there should have been some monetary limit set for disclosure of disposed of assets. For this I need SECP clarification if all the disposal are required to be disclosed if aggregate book value exceeds Rs. 500,000 limit or there should be some limit which needs to be applied e.g. disclosure of only those assets whose cost or book value exceeds Rs. 500,000.

Opinion:

The Board notes that a requirement similar to the clauses 15 and 10 of the 4th and 5th Schedule respectively, of the Companies Act 2017 also existed in the repealed Companies Ordinance, 1984 as Clause 4(ii) of the 4th Schedule. A comparison between the current and previous requirement is as under:

4th Schedule of Companies Act, 2017	4th Schedule of Companies Ordinance, 1984	Differences
In the case of sale of fixed assets, if the aggregate book value of assets ***exceeds five hundred thousand rupees****, following particulars of* ***each asset*** *shall be disclosed:* *(i) cost or revalued amount, as the case may be;* *(ii) the book value;* *(iii) the sale price and the mode of disposal (e.g. by tender or negotiation);* *(iv) the particulars of the purchaser;* ***(v) gain or loss; and*** ***(vi) relationship, if any of purchaser with Company or any of its directors.***	*In the case of sale of fixed assets, if the book value of the asset or assets* ***exceeds in aggregate fifty thousand rupees****, particulars of the assets* ***and in aggregate****:* *(a) cost or valuation, as the case may be;* *(b) the book value; and* *(d) the sale price and the mode of disposal (e.g. by tender or negotiation) and the particulars of the purchaser."*	The words highlighted in the bold text reflect the following differences between the current and previous requirement: (i) Previously, the prescribed disclosure was required when the aggregate book value of the fixed assets sold **exceeded fifty thousand rupees**. Whereas, now this threshold has been increased to **five hundred thousand rupees.** (ii) Previously, the companies were required to provide the specified disclosures **in aggregate for the fixed assets sold** during the year. Whereas, now the companies are required to provide the specified disclosures for **each asset sold** during the year. (iii) Disclosures about gain or loss and relationship with the purchaser have been added.

The Board notes that enquirer has sought clarification from the SECP as to whether the clauses 15 and 10 of the 4th and 5th Schedule, respectively require a company to provide specified disclosures separately for each asset sold during the year.

The Board understands that the wording of clauses 15 and 10 of 4th and 5th Schedule respectively, reflect that a company is required to provide specified disclosures pertaining to sale of fixed assets separately for each asset sold during the year.

(May 13, 2019)

2.1 Opinion on Retention of Audit Report and Copy of Financial Statements Signed by the Client

Enquiry:

Please refer to Directive 4.19 dated May 08-10, 2014 on retention and custody of working papers by Chartered Accountants Firms.

In the above referred directive, it is not clear whether or not working papers include audit report and copy of financial statements signed by the client. If these two documents also include in working papers, then it is clear that retention period of these documents would be the same as of other working papers. If not, then what is the retention period of these documents. You are requested to please guide on the matter

Opinion:

The Committee is of the view that the signed audited financial statements and the auditor's report thereon are an integral part of the audit working papers. The auditors should retain the audit working papers as per the requirements of ISQC 1 *Quality Control for Firms that perform Audits, Reviews of Financial Statements and Other Assurance and Related Services Engagement*, ISA 230 *Audit Documentation* and the Institute's Directive 4.19 *Retention and custody of working papers by Chartered Accountant Firms*.

(June 14, 2019)

2.2 Disclosure of Information to Managing Director of DEF Company Limited

Enquiry:

We, ABC & Co. Chartered Accountants, being the predecessor auditors of DEF Company (the Company), have been approached by the Managing Director (Government Nominee) of the Company to inspect our audit working papers and to make photocopies of other documents which we collected during our audit assignments. In response to the letter we sought guidance from Securities and Exchange Commission of Pakistan (SECP) which advised us to approach the Institute of Chartered Accountants of Pakistan (ICAP) for guidance in the subject matter. This letter is intended to seek your office's guidance whether or not the Managing Director is entitled to have the access to the information which is available with us under confidentiality agreement with the Company.

The information pertinent to the matter is as follow:

- DEF Company Limited (the Company) is listed on Pakistan Stock Exchange. Approximately 30 % shares of the Company are owned by different Government Institutions.

- The board of directors of the Company consists of nine directors. Out of which Managing Director and one other director are nominated by the Government of Pakistan through Ministry of Industry and Production.

- Board of directors of the Company, in a meeting held on December 14, 2018 resolved to remove the managing director under section 190(1) of Companies Act, 2017 and same was also intimated to Pakistan Stock Exchange as on January 04, 2019. The Securities and Exchange Commission of Pakistan (SECP) in its response to our letter stated that the Company has filed form 29 dated 30-01-2019 notifying the removal of CEO/ Director of the company.

- Some matters regarding transfer of shareholding and other disputes are pending adjudication at different forums.

- On the other hand, the Managing Director claims that the Company being a State-Owned Enterprise is operating under the Economic Reform Order, 1972 and the resolution of the board of directors has no legal standing and further the Managing Director is legally authorized to act in place of the board of directors under the Economic Reforms Order 1972.

In the given circumstances we are unable to ascertain the real ownership structure of the Company and any disclosure of information to any person who can be treated as unrelated will directly impact us as breach of confidentiality. Accordingly, we have come up before your honor to guide us to proceed further.

Opinion:

The Committee is of the view that in the enquired scenario as to whether the individual still holds the position of Managing Director / Chief Executive Officer is a legal matter. Therefore, on this matter the enquirer should seek legal guidance.

With regard to enquiry about sharing of information/documents prepared during the course of an audit engagement with an individual, it is to be noted that the audit working papers are used to document the information gathered during an audit. The audit working papers are property of the auditor and accordingly an auditor can restrict / decline access in accordance with the legal obligations and contractual terms of engagement with the engaging party.

Further, before allowing access to the audit working papers, the auditor has to consider the ethical requirements, including confidentiality. Confidentiality is one of the fundamental principles of Code of Ethics for Chartered Accountants. It outlines that a member is refrained from disclosing confidential information acquired as a result of professional and business relationships without proper and specific authority to disclose, unless there is a legal or professional right or duty to disclose.

Paragraph 140.7 of the Code of Ethics for Chartered Accountants explains the circumstances under which the confidential information can be disclosed. Relevant paragraph is reproduced, hereunder:

"*The following are circumstances where chartered accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:*

a) Disclosure is permitted by law and is authorized by the client or the employer;
b) Disclosure is required by law; and
c) There is a professional duty or right to disclose, when not prohibited by law."

It is also pertinent to mention following provisions of the Schedule II of the Chartered Accountants Ordinance 1961, which specifies that unauthorized disclosure of confidential information is a professional misconduct:

"A chartered Accountant in practice shall be deemed to be guilty of Professional misconduct, if he-

(1) discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force."

Based on above discussion, the auditor can provide access of work papers to other parties if such access has been authorised by the client or required by law.

(June 14, 2019)

2.3 Going Concern of a Private Limited Company

Enquiry:

The company (Private Limited) was facing operational losses and negative operational cash flows in last three years but post balance sheet date they are back to making good profits and positive operational cash flows. The directors had given loans to offset negative operational cash flow. These were classified as Equity. Positive Equity 10M at year end due to directors' loan. I would like to know:

1. Can the present results have any effect on this material uncertainty or past result should only be considered?

2. Can subsequent event remove Emphasis of Matter/ Material uncertainty section of Audit Report?

3. If the company is continuing to perform in 2019 can it be still said that material uncertainty existed?

4. If the Audit opinion is given after June 2019; and the company shows positive results for the next year, still the Material Uncertainty para is appropriate for past results?

5. If the Directors are giving loan to cover deficit and continue their support, still the material uncertainty para is appropriate.

Opinion:

The Committee noted that in accordance with the accounting and reporting standards as applicable in Pakistan an entity prepares financial statements on a going concern basis when, under the going concern assumption, the entity is viewed as continuing in business for the foreseeable future. The term 'foreseeable future' is not defined within International Standards on Auditing as applicable in Pakistan (ISAs). However, International Accounting Standard (IAS) 1, *Presentation of Financial Statements* deems the foreseeable future to be a period of 12 months from the entity's reporting date.

Entity's management is responsible to make the assessment of entity's ability to continue as a going concern. This assessment involves making a judgment at a particular point in time, on the basis of all available information. The assessment may include information available subsequent to the date of the end of the latest period covered by the financial statements.

ISA 570 (Revised) *"Going Concern"*, explains that the auditor will evaluate the management's assessment of the entity's ability to continue as a going concern covering the same period as covered by the management in accordance with the required financial reporting framework or by law or regulation if it specifies a longer period.

Under ISA 570, the auditor's responsibility includes:

a) to conclude on the appropriateness of managements use of going concern basis of accounting in the preparation of financial statements;

b) to conclude, based on the audit evidence obtained up to the date of the audit report, whether a material uncertainty exists relating to events or conditions that may cast significant doubt on the company's ability to continue as a going concern; and

c) to ensure that the disclosures made in the financial statements regarding management's critical judgment and assessment of the company's ability to continue as a going concern are adequate.

ISA 570, paragraph 5 explains that *"Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment."*

- *The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.*

- *The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.*

- *Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.*

In accordance with the ISAs, before the sign-off of the auditor's report, auditor is responsible to ensure that all significant subsequent events that occurred between the date of the financial statements and the date of the auditor's report have been adequately disclosed in and/or adjusted in the audited financial statements. This is required in accordance with ISA (Revised) 700 "*Forming an Opinion and Reporting on Financial Statements*". Relevant paragraph A66 of ISA 700 explains that "*the date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date."*

With regard to the subsequent events, ISA 560 "*Subsequent Events*", paragraph 2 states that *"financial statements may be affected by certain events that occur after the date of the financial statements"*. The subsequent events are defined as *"events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor before the date of auditor's report.*

ISA 560 paragraph 6 states that *"the auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions."*

ISA 570 (Revised) paragraph 16 outlines that auditor shall perform additional audit procedures when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include consideration of any additional facts or information that has become available since the date management made its assessment.

Further paragraph A16 of ISA 570 (Revised) lists down the additional audit procedures that an auditor shall consider when conditions and events are identified which may cast significant doubt on the entity's ability to continue as a going concern. These procedures are carried out on the latest available information and as listed in A16 of ISA 570, include:

- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity's latest available interim financial statements.
- Reading the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Evaluating the entity's plans to deal with unfilled customer orders.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.
- The prospective financial information for recent prior periods with historical results; and
- The prospective financial information for the current period with results achieved to date.

Where management assumptions include continued support by third parties whether through subordination of loans, commitment to maintain or provide additional funding, or guarantees and such support is important to the company's ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including the terms and conditions) from those third parties and to obtain their ability to provide such support

Further, the auditor in accordance with ISA 580 "*Written Representations*", may consider it appropriate to obtain specific written representations in addition to the audit evidences obtained regarding management's plans for future actions in relation to its going concern assessment and the feasibility of those plans.

Based on above discussion, the Committee is of the view that in accordance with ISA 570 auditor is responsible to determine whether going concern assumption used by the management of the company is appropriate. In this regard the auditor shall consider and respond to the subsequent events, in accordance with the guidance provided in ISA 560.

(June 20, 2019)