

Selected Opinions

Volume XXV

From July 1, 2019 to June 30, 2020

Technical Services Department

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Note: The selected opinions 1.1 - 1.5 and 1.10 - 1.11 have been previously published in the twenty-fourth compilation of selected opinions issued last year on December 31, 2019. This was done due to the fact that the twenty-fourth compilation covered the opinions issued from July 1, 2018 till December 31, 2019 (i.e. 18 months) as compared to the Insitute's previous practice of issuing a compilation for a period of July till June for each year (12 months).

Therefore, in order to make each compilation of selected opinions consistent in terms of coverage period, the selected opinions 1.1-1.5 and 1.10 - 1.11 have been deleted from the twenty-fourth compilation and included in twenty-fifth compilation.

Introduction

This is the twenty fifth 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 2019 to June 2020**. This compilation of opinions is termed as "Selected Opinions".

During the period from July 2019 to June 2020, the Board issued written responses on 16 accounting enquiries. However, this compilation only includes the Board's responses on the accounting enquiries which are relevant for guidance of general membership. Accordingly, this compilation does not include the Board's written responses on the enquiries received from the regulators (such as SECP and SBP) on regulatory matters relating to financial reporting.

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 Accounting for Moulds under IAS 16 *Property, Plant & Equipment*

Enquiry:

Our company is a listed company primarily engaged in manufacturing and sale of glass container bottles and glass tableware. Details of company's products are as follows:

S.No	Sector	Brief Information
1.	Beverage	includes flint, amber and green colour glass bottles for beverage companies.
2.	Food	which includes flint colour glass bottles for food companies (i.e. jam jars, ketchup bottles, tang jar)
3.	Pharma	Flint and Amber pharmaceutical bottles
4.	Tumblers	Tumblers, tea and juice mugs, jugs, bowls, plates, ash tray, ice bucket etc.

Company's major production is dependent upon job order basis as well as general production for various companies having similar designs of bottles. Company manufactures its products using dismountable moulds in order to maintain production of variety of articles/products.

Each mould is developed/purchased for specific order based on confirmed or expected orders, therefore, each mould has variable useful life depending on the projected sales volume. The production life of mould in each sector is given below:

S.No	Sector	Average Mould Life	Remarks
1.	Beverage, Food and Pharma	70,000 to 80,000 Gross	If mould is operated continuously then each mould has a life of around two months production on one machine.
2.	Tableware	Average of around 200,000 Gross	If we operate continuously then each mould has life of around 5 months' production on one machine.

Explanation:

- One Gross = 144 bottles
- Company's mould inventory normally consists of more than 150 no.
- Company has multiple machines so at a time minimum 7 to 8 different moulds are in production individually on each machine and moulds are replaced after desired planned production
- Company has different production lines for each type of glass (i.e. separate production lines/furnaces for tableware & food/beverage/pharma)

Since there is huge production range in food, beverage and tableware sector, sometimes few moulds are consumed during the year. Whereas, in other cases few moulds remain unconsumed at year end i.e. these are partially consumed (i.e. say 35,000 gross is produced or 50/40% consumed).

Since, moulds used in the production process are classified as store inventory so these are sent back to store and their proportionate consumption is charged to statement of profit or loss (charged in 'Cost of Sales' under the head 'Stores and Spares Consumed' on the basis of each production batch i.e. their carrying cost is reduced based on units produced from each mould).

Continuous production from the same mould would result in full consumption within 60-150 days. However, in most cases these moulds are dismantled after completion of specific batch

order and replaced with moulds for production of other products, therefore, most of the moulds are not consumed in year of purchase (year 1) but they are partially consumed in year 1 and then remaining in year 2 or 3.

In addition, at the end of each reporting period, an assessment on impairment of moulds is made and provisions with regard to defunct/damaged moulds are considered and recorded accordingly.

The company has been consistently following the policy of recording moulds under the head 'Stores, Spares & Loose Tools' since decades. However, the auditors have made objection that these moulds should be recorded in non-current assets based on the fact that the moulds have useful life of more than one year and therefore should be classified as non-current assets in accordance with paragraph 6 of IAS 16.

The opinion of auditors is drawn from the fact that in some cases of small orders one mould is consumed partially in year 1 (50%) whereas other remaining part is consumed in year 2 or even sometimes in year 3. The management has raised its concern on this treatment with the auditors that if a mould is purchased and consumed in same year, it seems strange that we add mould in fixed assets and then also charge full depreciation in the same year.

The company further believes that there will be no effect on gross or net profitability of the company on reclassification of moulds in property, plant and equipment because the consumption pattern of moulds shall remain same whatsoever.

In the light of the above mentioned submissions, we seek the Board's guidance on the following matters:

Whether the company should continue recording moulds as stores and spares item as per previous practice or change the classification and record them as property, plant and equipment. Further, what would be the accounting treatment of moulds which may be fully consumed in next 12 months or consumed within 12 months of their purchase.

Guidance on whether the said change in accounting treatment be accounted for as a change in accounting policy or mere change in classification of moulds from stores, spares and loose tools in current assets to property, plant and equipment in non-current assets.

Opinion:

The Board finds it important to highlight that where an expenditure item meets the recognition criteria for an asset as outlined in the "Conceptual Framework for Financial Reporting", an entity refers to definitions of different types of assets (e.g. property, plant and equipment, inventory, financial asset etc.) provided in the individual IFRSs pertaining to recognition of assets in order to ascertain proper recognition, measurement and disclosure requirements. This principle is also highlighted in paragraph 8 of IAS 16, which states (emphasis added):

"Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this IFRS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory."

The Board noted that paragraph 6 of IAS 16 defines "Property, Plant and Equipment" as:

"Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.”

Further, paragraph 6 of IAS 2 defines “Inventories” as:

“Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.”

In the context of the enquired scenario, the Board noted that condition (a) in the definition of property, plant and equipment appears to be clearly satisfied as the moulds are being used in the production of glass bottles/jars which are sold to the customer. However, with respect to condition (b) in the definition, management needs to assess and make judgement considering all the pertinent fact and circumstances as to whether the moulds are expected to be used during more than one period.

Based on the submissions of the enquirer, the Board noted that each mould has a defined output capacity, i.e. number of bottles it can produce over its economic life. Further, the company mainly sells its products on a job order basis and a mould is purchased/developed specifically for a particular job. Therefore, in order to ascertain whether a mould meets the condition (b) i.e. expected to be used during more than one period, and hence the definition of property plant and equipment, the management needs to assess and estimate whether:

- the entity will utilize its entire output capacity within a single period; or
- the entity will utilize its entire output capacity in more than one period.

In other words, the entity would need to assess the “Useful Life” of mould at the time of initial recognition. Useful life can be determined as either a period of time or number of production units expected to be obtained by the entity. Useful life is defined in paragraph 6 of IAS 16 as:

“Useful life is:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.”

The Board noted that paragraph 57 of IAS 16 explains that the useful life of an asset is defined in terms of the asset’s expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of an asset is a matter of judgement based on the experience of the entity with similar assets.

Further, paragraph BC 30 of IAS 16 clarifies that useful life of an item of property, plant and equipment also includes the period it is idle, provided it is available for the entity’s use. Paragraph BC 30 of IAS 16 states:

“The Board decided that the useful life of an asset should encompass the entire time

it is available for use, regardless of whether during that time it is in use or is idle. Idle periods most commonly occur just after an asset is acquired and just before it is disposed of, the latter while the asset is held either for sale or for another form of disposal.”

The Board noted that in the enquired scenario the enquirer submits that in case of some orders, the output capacity of mould is utilized within one year, whereas in case of other orders the output capacity of a mould is utilized in more than one year. Keeping in view, the aforementioned guidance of IAS 16, the Board understands that the moulds of the company can be categorized into two categories:

- i) moulds whose entire output capacity is utilized within one year; and
- ii) moulds whose entire output capacity is utilized in more than one year.

To the Board’s understanding, the moulds which fall into category (ii) appear to fulfill the definition of property, plant and equipment and therefore, should be recognised as property, plant and equipment and depreciated over their useful life. Whereas, the moulds which fall into category (i) appear to fulfill the definition of inventory and should be recognised as such under IAS 2 and charged as expense in the cost of sales in the year in which the entire output capacity of the mould is utilized.

Further, the Board understands that current practice of the company of recognizing entire mould inventory as stores, spares and loose tools, and charging off proportionate amount of output capacity utilized in cost of sales is not in line with the requirements of IAS 16.

The Board also finds it pertinent to highlight that as required in paragraph 60 of IAS 16, the depreciation method for the moulds recognised as property, plant and equipment should reflect the pattern in which future economic benefits are expected to be consumed by the entity. Paragraph 62 of IAS 16 provides further guidance on selection of depreciation method as follows:

“A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. Straight-line depreciation results in a constant charge over the useful life if the asset’s residual value does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.”

In the context of the enquired fact pattern, the Board understands that production of units from moulds is the key driver of consumption of the future economic benefits and therefore, units of production method appears to be the most suitable depreciation method for the moulds recognised as property, plant and equipment.

Further, the Board noted that the enquirer has also sought guidance on whether the said change in accounting treatment should be accounted for as a change in accounting policy or mere change in classification of the moulds from stores, spares and loose tools in current assets to the property, plant and equipment in non-current assets. In this respect, the Board noted that guidance is provided in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Paragraph 14 of IAS 8 states:

“An entity shall change an accounting policy only if the change:

(a) is required by an IFRS; or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity’s financial position, financial performance or cash flows.”

In the enquired fact pattern, the Board understands that the recognition of the entire moulds inventory as stores spares and loose tools in the past is an improper application of the requirements of IAS 16 and IAS 2. In other words, it in effect reflects a mistake in applying proper accounting policies. The Board is of the view that the adjustment in the financial statement to rectify this situation, cannot be regarded as a change in accounting policy on the grounds that it would result in the financial statements providing reliable and more relevant information. The rectification in the enquired scenario, in the Board’s view, constitutes correction of prior period errors. Prior period errors are defined in IAS 8 as (emphasis added):

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

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

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

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.”

Therefore, the Board is of the view that the rectification of the financial statements in the enquired fact pattern should be accounted for as a correction of prior period errors in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

(August 26, 2019)

1.2 Treatment of employer's unpaid contribution to defined benefit fund under IAS 26 *Accounting & Reporting by Retirement Benefit Plans*

Enquiry:

It has been practice of the companies and firms to show "Receivable from Employer" in the financial statements of the defined benefit plans. But as per the "Topic Wise Selected Opinions" on IAS 26 *Accounting & Reporting by Retirement Benefit Plans*, issued by the Institute of Chartered Accountants of Pakistan, unpaid contributions cannot form part of the "Net assets available for benefits" in the separate financial statements of a defined benefit plan and may be disclosed in the notes.

As per the definition of the Net assets available for benefits given in IAS 26, assets of plan less liabilities are the Net assets available for benefits. Definition from IAS 26 paragraph 8 is reproduced below:

'Net assets available for benefits are the assets of a plan less liabilities other than the actuarial present value of promised retirement benefits.'

Please note that as per the definition of an asset, the amount "Receivable from Employer" is also an asset. Our query is that why the Institute has not considered the "Receivable from Employer" as an asset of defined benefit plan, when the company shows it as an obligation to pay in its financial statements and confirms it as its liability and the fund also says that it is an asset in form of receivable from employer. Please note further that IAS 26 also has not restrained from recognizing it as an asset then why we cannot recognize it as an asset in financial statements of fund. Copy of the Topic Wise Selected Opinions on IAS 26 issued by the Institute of Chartered Accountants of Pakistan is enclosed for your ready reference.

We would appreciate ICAP's views and necessary clarification on the above mentioned query.

Opinion:

The Board considers it pertinent to highlight that as per the enquirer's submissions, the enquirer is of the opinion that as per the definition of an asset, the amount receivable from employer or unpaid contributions is also a plan asset (of defined benefit fund). Therefore, in the light of principles outlined in the *Conceptual Framework for Financial Reporting* (the Framework) and IFRS Standards in general, the Board noted that determination of whether unpaid contributions from an employer towards a defined benefit fund, fulfill the definition of an asset needs careful assessment.

The Board noted that previously, the Technical Advisory Committee (TAC) of the Institute, in its opinion (dated January 11, 2016) concluded that unpaid contributions cannot form part of the 'Net assets available for benefits' in the separate financial statements of a defined benefit plan and may only be disclosed in the notes. TAC in its analysis also highlighted that paragraphs 17 and 28 of IAS 26 explain different formats of presentation of net assets and actuarial obligation. Further, these paragraphs do not prescribe that the amount not yet contributed by the company is part of the Net assets available for benefits.

While reconsidering the matter, the Board considered that paragraph 4.3 of the Framework defines an asset as:

"An asset is a present economic resource controlled by the entity as a result of past events."

Further, paragraph 4.4 states that an economic resource is a right that has the potential to produce economic benefits. Paragraphs 4.6 - 4.7 explain that rights that have the potential to

produce economic benefits take many forms, including:

- (a) rights that correspond to an obligation of another party, for example:
 - (i) rights to receive cash.
 - (ii) rights to receive goods or services.
 - (iii) rights to exchange economic resources with another party on favourable terms. Such rights include, for example, a forward contract to buy an economic resource on terms that are currently favourable or an option to buy an economic resource.
 - (iv) rights to benefit from an obligation of another party to transfer an economic resource if a specified uncertain future event occurs.
- (b) rights that do not correspond to an obligation of another party, for example:
 - (i) rights over physical objects, such as property, plant and equipment or inventories. Examples of such rights are right to use a physical object or a right to benefit from the residual value of a leased object.
 - (ii) rights to use intellectual property.

The Board understands that it can be inferred from the above paragraphs that, for unpaid contribution to a defined benefit fund to meet the definition of an asset, it must correspond to an obligation of the other party, i.e. the company making the contributions.

The Board would like to highlight that guidance on obligation of employer under various types of post-employment benefit plans, is outlined in IAS 19 *Employee Benefits*.

Defined contribution plans and defined benefit plans are defined in IAS 19 as under:

“Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further.”

“Defined benefit plans are post-employment benefit plans other than defined contribution plans.”

Further, the Board noted paragraph 114 of IAS 19 outlines that (emphasis added):

“Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.”

The Board understands that, in context of employer’s financial statements, the employer’s interest is a net liability or asset that reflects a long-term measure of the cash inflows and outflows of the defined benefit plan. Cash inflows include cash generated from the assets of the defined benefit plan and contributions from employees; cash outflows include the payment of benefits. Under such an approach, the employer would recognise a liability when there is a shortfall in expected cash flows of the defined benefit plan that has to be met by the employer, i.e. when the cash flows from the assets of the defined benefit plan are not expected to be sufficient to meet its liabilities. Measurement of the liability would then reflect the employer’s obligation to pay contributions to the defined benefit plan in order that

the plan can meet its liabilities when they fall due. Similarly, the employer would recognise an asset when there is a surplus in expected cash flows of the defined benefit plan and the employer had the right to benefit from that surplus.

In relation to the entity's funding obligations, IAS 19 requires an entity to disclose the employer's best estimate, as soon as it can be reasonably determined, of contributions expected to be paid to the plan during the annual period beginning after the balance sheet date.

Paragraph 30 of IAS 19 states that under defined benefit plans, the entity's obligation is to provide the agreed benefits to current and former employees and actuarial risk (that benefits will cost more than expected) and investment risk will fall, in substance, on the entity. If actuarial or investment experience are worse than expected, the entity's obligation may be increased.

The Board noted that the financial statement content of a defined benefit plan is explained in IAS 26 *Accounting and Reporting by Retirement Benefit Plan*.

Paragraph 28(a) of IAS 26 states that *"a statement is included in the financial statements that shows the net assets available for benefits, the actuarial present value of promised retirement benefits, and the resulting excess or deficit"*.

IAS 26 defines net assets as follows:

"Net assets available for benefits are the assets of a plan less liabilities other than the actuarial present value of promised retirement benefits."

The Board would like to highlight that the deficit in a defined benefit plan would only arise, if contribution receivable from entity, as discussed in query, is not recognized in the books of account of defined benefit plan.

Other formats of presentation of financial statements of defined benefit plan under IAS 26 do not explicitly differ in terms of such non-recognition.

In context of the submitted fact pattern, the Board noted that USGAAP [ASC 960] can also be referred for explanation purposes. ASC 960-310-25(4) outlines that the unfunded prior service costs are not receivables of the plan because at the reporting date those amounts are not due from the employer(s). The employer(s) may or may not intend to eventually contribute amounts sufficient to eliminate the unfunded prior service costs. Until such payments are formally committed to the plan, unfunded prior service costs do not constitute a recordable resource of the plan. For similar reasons, any existing excess of the actuarial present value of accumulated plan benefits over the net assets available for benefits (excluding contributions receivable) is not a plan asset unless at the reporting date that amount is legally, contractually, or pursuant to a formal commitment due the plan.

The Board understands that plan assets include all those assets over which plan has beneficial ownership interest, generally, the employer contributions become an asset of the plan only when the contribution has been made, rather than when the contribution become due under the plan.

Accordingly, it is to be noted that until paid, the employer contributions specifically included in the plan's statutory arrangement i.e. the unpaid contributions are not plan assets, and are not creditor protected.

(August 27, 2019)

1.3 Revenue recognition in immigration business under IFRS 15 *Revenue from Contracts with the Customers*

Enquiry:

We are in immigration service business. We have a number of customers who make 100% outright payment and some pay in installments.

All the payments made by customers are non-refundable.

Should we record revenue based on receipt basis considering non-refundable nature? OR at the time of final decision by relevant immigration authority. Stage of completion is difficult to explain.

The enquirer was later contacted to provide further clarity on the specific performance obligations included in a contract of immigration service. The further information provided by the enquirer is as follows:

The scope of service in immigration of any country is outlined below. I want to know about the allocation of consideration based on below mentioned process.

1. To sign contract with the customer
2. To collect all required documents from client and perform due diligence.
3. To prepare the client's application for citizenship of ABC Country.
4. To lodge the application with the relevant embassy.
5. Decision from relevant government.

Normally, we used to collect 1/3rd at signing of contract, 1/3rd on receipt of all documents and 1/3rd on application submission and I think we should recognize accordingly. Need the input of institute for the best judgement for revenue recognition.

Further, as per the industry practice, all of the above services are offered to customers as a single package with an overall contract price.

Opinion:

The Board would like to highlight that the core principle of IFRS 15 is that, an entity recognizes 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. Therefore, an entity recognizes revenue in accordance with this core principle by applying the following steps:

- i. Identify the contract(s) with a customer;
- ii. Identify the performance obligation in the contract;
- iii. Determine the transaction price;
- iv. Allocate the transaction price to the performance obligations in the contract; and
- v. Recognise revenue when (or as) the entity satisfies a performance obligation.

The Board noted that for step (i) above, i.e. identifying the contract with a customer, paragraph 9 of IFRS 15 requires that an entity shall account for a contract with a customer that is within the scope of IFRS 15 only **when all of the following criteria are met:**

- (a) the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations;
- (b) the entity can identify each party's rights regarding the goods or services to be transferred;
- (c) the entity can identify the payment terms for the goods or services to be transferred;
- (d) the contract has commercial substance (i.e. the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and
- (e) it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract, if the consideration is variable because the entity may offer the customer a price concession.

The Board further noted that while explaining the above conditions, paragraph 10 of IFRS 15 states that a contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. It further explains that an entity shall consider practices and processes for establishing contracts with customers in determining whether and when an agreement with a customer creates enforceable rights and obligations.

Further, based on the enquirer's submissions, the Board understands that all the payments made by customers are non-refundable. However, the Board finds it important to highlight that non-refundability of consideration in a contract does not imply that the parties do not have enforceable rights and obligations under the contract. Therefore, the Board understands that despite the fact that consideration paid under the contract is non-refundable, there must be some performance obligations which must be satisfied to earn the consideration.

The Board noted that, under paragraph 15 of IFRS 15, even when a contract with a customer does not meet the criteria laid down in paragraph 9, and an entity receives consideration from the customer, the entity shall recognise the consideration received as revenue only when either of the following events has occurred:

- (a) the entity has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable; or
- (b) the contract has been terminated and the consideration received from the customer is non-refundable.

Paragraph 16 further explains that an entity shall recognise the consideration received from a customer as a liability until one of the events above occur or until the criteria in paragraph 9 of IFRS 15 are subsequently met.

Therefore, the Board understands that recognition of revenue on receipt basis regardless of fulfillment of performance obligations, is not in line with the core principle outlined in IFRS 15. Accordingly, in accordance with the five-step model of IFRS 15, the entity should identify the performance obligations in the contract, allocate the transaction price to performance obligations and recognise revenue when (or as) it satisfies a performance obligation. The Board noted that IFRS 15 contains detailed application guidance in this respect.

Further, the Board noted that for identifying the performance obligations paragraph 22 of IFRS 15 requires that at contract inception, an entity shall assess the goods or services promised in a contract with a customer, and shall identify as a performance obligation each promise to transfer to the customer either:

- (a) a good or service (or a bundle of goods or services) that is distinct; or
- (b) a series of distinct goods or services that are substantially the same and that have same pattern of transfer to the customer.

Further, paragraph 25 explains that performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer. For example, a service provider may need to perform various administrative tasks to setup a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation. Accordingly, the Board understands that in the submitted fact pattern, activities such as signing contract and collecting documents would not constitute a performance obligation.

The Board noted that paragraph 27 of IFRS 15 states that a good or service that is promised to a customer is distinct if both of the following criteria are met:

- (a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e. the good or service is capable of being distinct); and
- (b) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. the promise to transfer the good or service is distinct within the context of the contract).

This is further explained in paragraphs 28-29 of IFRS 15 that a customer can benefit from a good or service in accordance with paragraph 27(a), if the good or service could be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

Further, in assessing whether an entity's promise to transfer goods or services to the customer is separately identifiable in accordance with paragraph 27(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

- (a) the entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined

output or outputs specified by the customer. A combined output or outputs might include more than one phase, element or unit.

- (b) one or more of the goods or services significantly modifies or customises, or are significantly modified or customised by, one or more of the other goods or services promised in the contract.
- (c) the goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfil its promise by transferring each of the goods or services independently.

Based on the enquirer's submissions, the Board understands that as per the industry practice, immigration consultancy services are offered to customers as a single package with an overall contract price. It transpires that a customer cannot benefit from the component services either on their own or together with other readily available resources and the company's promise to transfer the component services are not separately identifiable from other promises in the contract. Accordingly, the Board understands that the conditions in paragraph 27 of IFRS 15 does not appear to be satisfied and the component services in an immigration consultancy contract does not appear to be a distinct service.

The Board would like to highlight that under paragraph 30 of IFRS 15, if a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation. Accordingly, for the reasons discussed in paragraph 8 above, the Board understands that the entire contract of immigration services would be treated as a single performance obligation.

As a result, the Board understands that the company is also not required to allocate the transaction price to different performance obligations as the contract for immigration services has only one performance obligation.

The Board noted that under paragraph 31 of IFRS 15, an entity is required to recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. Paragraph 32 explains that for each performance obligation, an entity shall determine at contract inception whether it satisfies the performance obligation over time or satisfies a performance obligation at a point in time.

Further, paragraph 35 of IFRS 15 explains that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

- (a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
- (b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced; or
- (c) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Paragraph B3-B4 of the Application Guidance of IFRS 15 states that for some types of performance obligations, the assessment of whether a customer receives the benefits of an

entity's performance as the entity performs and simultaneously consumes those benefits as they are received will be straightforward. Examples include routine or recurring services (such as a cleaning service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

For other types of performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In those circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially re-perform the work that the entity has completed to date if that other entity was to fulfil the remaining performance obligation to the customer. In the context of the submitted fact pattern, the Board understands that if the processing of immigration consultancy has progressed to a certain stage but is then terminated and another consultant is hired, it is apparent that the new consultant would not need to substantially re-perform the work that the previous consultant has completed to date. Accordingly, to the Board's understanding, it can be concluded that under immigration consultancy services, a customer simultaneously receives and consumes the benefits from services and the performance obligation in this case is satisfied overtime.

The Board further noted that for each performance obligation satisfied over time, paragraphs 39-40 require that an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring the progress is to depict an entity's performance in transferring control of goods or services promised to a customer (i.e. satisfaction of an entity's performance obligation). An entity shall apply a single method of measuring progress for each performance obligation satisfied over time and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress towards complete satisfaction of a performance obligation satisfied over time.

Further, paragraphs 41-43 prescribe two types of methods of measuring progress of satisfaction of performance obligation, i.e. output methods and input methods. In determining, the appropriate method for measuring progress, an entity shall consider the nature of the good or service that entity promised to transfer to the customer.

Paragraph B15 explains that output methods recognise revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed and units produced or units delivered. When an entity evaluates whether to apply an output method to measure its progress, the entity shall consider whether the output selected would faithfully depict the entity's performance towards complete satisfaction date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

Paragraph B18 explains that input methods recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognise revenue on a straight-line basis.

The Board also considered the enquirer's submission regarding the difficulty involved in explaining the stage of completion of services. In this regard, the Board considers it pertinent to highlight that mere difficulty in application does not provide relevant grounds for non-application of an IFRS requirement. Departure from requirements of IFRSs is permitted only in

extremely rare circumstances, when its application is ‘impracticable’. IFRS Standards set a very high threshold for impracticability in application of a requirement.

Paragraph 7 of IAS 1 states that *‘applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so...’*

Therefore, the Board is of the view that the management needs to exercise judgement and make every reasonable effort to apply an input or output method in ascertaining the progress of satisfaction of performance obligation in the contract.

(August 27, 2019)

1.4 Accrual of mark-up on a defaulted loan under IFRS 9 *Financial Instruments - Recognition & Measurement*

Enquiry:

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

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

Our directors are of the view that because the tenure of the repayment has elapsed, therefore, we should not accrue markup anymore and reverse such accounted for liability.

Please communicate us your professional advice regarding accrual of Markup.

Opinion:

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

“A financial liability is any liability that is:

(a) a contractual obligation:

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

or

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

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

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

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

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

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

“3.3.3 The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.”

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

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

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

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

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

“(1) It shall be the duty of a customer to fulfil his obligations to the financial institution.

(2) Where the customer defaults in the discharge of his obligation, he shall be liable to pay, for the period from the date of his default till realization of the cost of funds of the financial institution as certified by the State Bank of Pakistan from time to time, apart from such other civil and criminal liabilities that he may incur under the contract or rules or any other law for the time being in force.

(3) For purposes of this section a judgment against a customer under this Ordinance shall mean that he is in default of his duty under sub-section (1), and the ensuing decree shall provide for payment of the cost of funds as determined under sub-section (2).”

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

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

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

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

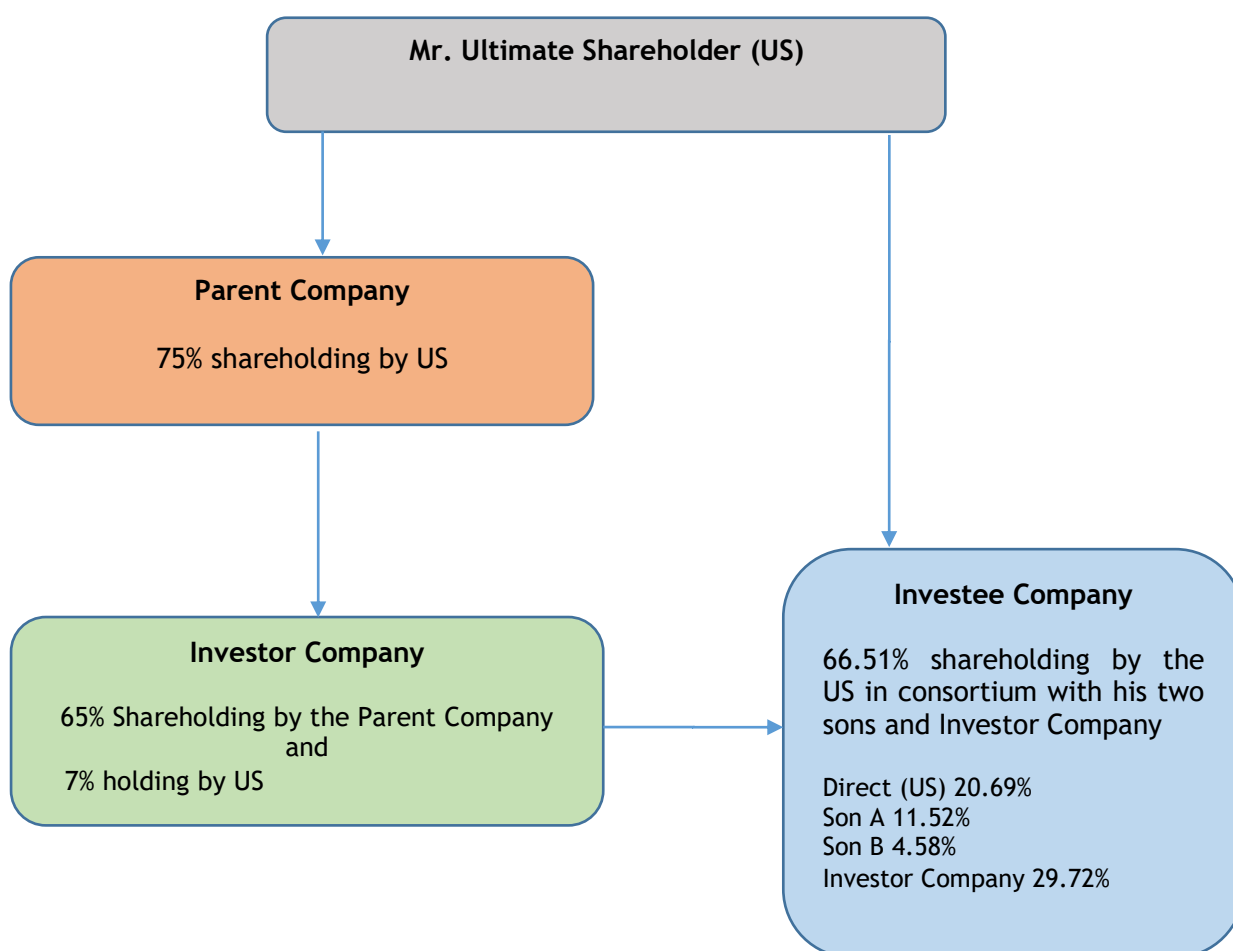
(October 9, 2019)

1.5 Assessment of Associated Company, Related Party & Associate Relationship

Enquiry:

The opinion of the Accounting Standards Board (ASB) is sought on certain questions on assessment of Associated Company, Related Party & Associate relationship in the undermentioned scenario:

Structure of Shareholding & Board Composition



Other facts

1. There has been no representation of Investor Company on the board of directors of the Investee Company. Also there is no common directorship in both the Companies
2. There has been no participation in policy making processes
3. There has been no material transaction between the Investor Company and the Investee Company
4. There has been no interchange of managerial personnel
5. There has been no provision of essential technical information
6. Ultimate Shareholder and his Son A & B are directors of Parent Company

7. Son A, Spouse of Son A, and Son B are the directors of Investee Company
8. Son A and Son B are independent from his father, Mr. US, which is confirmed as both run separate businesses (Son A's company is a major supplier of Investee Company and Son B's company is a major customer). Neither Son A and B nor their companies have any significant/major transactions with the Investor Company.
9. Investee Company has seven directors all were elected in accordance with the provisions of section 159 of the Companies Act, 2017 without the voting of shares, and were not nominated by Ultimate Sponsors, Parent Company or Investor Company.
10. Management of Investor Company has provided representation to us that:
 - there has been no representation of Investor Company on the board directors of the Investee Company;
 - there has been no participation of Investor Company in policy making process of the Investee Company
 - there has been no transaction between the Investor Company and the Investee Company; and
 - there have been no interchange of managerial personnel and there have been no provision of essential technical information. Accordingly, the Investor Company does not have significant influence over the Investee Company.

During the course of audit, we have not come across any evidence which contradicts with the aforementioned management representation.

Questions / Enquiries:

1. Whether Investor Company and Investee Company are 'associated companies' within the meaning of section 2(4) of the Companies Act, 2017?
2. Whether Investor Company and Investee Company are 'related parties' within the purview of the definition of a related party provided in paragraph 9 of the International Accounting Standard (IAS) 24 *Related Party Disclosures*?
3. Whether, as per IAS 28 *Investments in Associates and Joint Ventures*, Investee Company is an associate of Investor Company and, accordingly, whether Investor Company is required to account for its investment in Investee Company using the equity method of accounting?
4. Since both the Companies, Investor Company and Investee Company are ultimately controlled by a single shareholder, in this scenario whether, as per IAS 28 *Investments in Associates and Joint Ventures*, Investee Company is an associate of Investor Company and, accordingly, whether as a result of ultimate control by a single shareholder, Investor Company is or is not required to account for its investment in Investee Company using the equity method of accounting?

Opinion:

Q.1. Whether Investor Company and Investee Company are 'associated companies' within the meaning of section 2(4) of the Companies Act, 2017?

The Board noted that Section 2(4)(a) of the Companies Act, 2017 defines 'associated companies' as follows:

“associated companies and –associated undertakings mean any two or more companies or undertakings, or a company and an undertaking, interconnected with each other in the following manner, namely:

if a person who is owner or a partner or director of a company or undertaking, or who, directly or indirectly, holds or controls shares carrying not less than twenty percent of the voting power in such company or undertaking, is also the owner or partner or director of another company or undertaking, or directly or indirectly, holds or controls shares carrying not less than twenty percent of the voting power in that company or undertaking; “

(Underline is ours)

From the group structure shared by the enquirer, the Board understands that Mr. Ultimate Shareholder (US) has both direct and indirect holding in both Investor Company and Investee Company.

The calculation of effective shareholding of Mr. US (both direct and indirect) in the Investor Company and Investee Company would be as follows:

Mr. US's holding (effective) in Investor Company

Direct holding of US in Investor Company:	7%
Indirect holding of US in Investor Company (75% X 65%):	48.75%
Effective holding of US in Investor Company	55.75%

Mr. US's holding (Effective) in Investee Company

Direct holding of US in Investee Company	20.69%
Indirect holding of US in Investee Company (75% X 65% X 29.72%)	14.48%
Effective holding of US in Investee Company	35.17%

From the above calculation, the Board noted that Mr. US effectively holds 55.75% shareholding in Investor Company and 35.17% shareholding in Investee Company. Therefore, in terms of Section 2(4)(a) of the Companies Act, 2017, Mr. US directly or indirectly holds or controls shares carrying not less than twenty percent of voting power in both the Investor Company and Investee Company.

Q.2. Whether Investor Company and Investee Company are ‘related parties’ within the purview of the definition of a related party provided in paragraph 9 of the International Accounting Standard (IAS) 24 Related Party Disclosures?

The Board would like to highlight that paragraph 9 of IAS 24 defines related party as follows:

“A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the ‘reporting entity’).

a) A person or a close member of that person’s family is related to a reporting entity if that person:

I. has control or joint control of the reporting entity;

II. has significant influence over the reporting entity;

III. is a member of key management personnel of the reporting entity or of a

parent of the reporting entity.

b) An entity is related to a reporting entity if any of the following conditions applies:

- I. The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).*
- II. One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).*
- III. Both entities are joint ventures of the same third party.*
- IV. One entity is a joint venture of a third entity and the other entity is an associate of the third entity.*
- V. The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.*
- VI. The entity is controlled or jointly controlled by a person identified in (a).*
- VII. A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).*
- VIII. The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.*

In view of above, the Board understands that a related party is a person or an entity that is related to the reporting entity:

- A person or a close member of that person's family is related to a reporting entity if that person has control, joint control, or significant influence over the entity or is a member of its key management personnel.
- An entity is related to a reporting entity if, among other circumstances, it is a parent, subsidiary, fellow subsidiary, associate, or joint venture of the reporting entity, or it is controlled, jointly controlled, or significantly influenced or managed by a person who is a related party.

Further, the definition includes relationships involving direct and indirect control, including common control and significant influence.

In context of the submitted fact pattern, the Board noted that the entity (i.e. Investee Company) is related to the reporting entity (Investor Company) as Investee Company is controlled by Mr. US through his effective shareholding of 35.17%. As mentioned by the enquirer both the companies, Investor Company and Investee Company are ultimately controlled by a single shareholder.

Therefore, in accordance with paragraph 9(b)(iv) of IAS 24, the Board understands that Investor Company and Investee Company are related parties by virtue of control of Mr. US control of these companies.

Further, in terms of paragraph 9(b)(ii) of IAS 24, an associate or joint venture of the reporting

entity is also a related party. However, the Board noted that in the enquired fact pattern, whether the Investor Company has significant influence over Investee Company is not clear and it is also subject of questions 3 and 4 in the enquiry. Accordingly, as discussed in detail in responses to questions 3 and 4, if the management considering relevant facts and circumstances concludes that the Investor Company has significant influence over the Investee Company, the investor-associate relationship in terms of IAS 28 and additionally related party relationship due to investor-associate relationship under IAS 24 would be established.

Therefore, in accordance with paragraph 9(b)(iv) of IAS 24, the Board understands that Investor Company and Investee Company are related parties by virtue of control of Mr. US control of these companies.

Q.3. Whether, as per IAS 28 Investments in Associates and Joint Ventures, Investee Company is an associate of Investor Company and, accordingly, whether Investor Company is required to account for its investment in Investee Company using the equity method of accounting?

Q.4. Since both the Companies, Investor Company and Investee Company are ultimately controlled by a single Shareholder, in this scenario whether, as per IAS 28 Investments in Associates and Joint Ventures, Investee Company is an associate of Investor Company and, accordingly, whether as a result of ultimate control by a single shareholder, Investor Company is or is not required to account for its investment in Investee Company using the equity method of accounting?

The Board would like to highlight that when determining the appropriate accounting for its ownership interest in an investee, the investor must consider the substance of the transaction as well as the legal form of the investee.

Generally, the equity method of accounting should be applied when the investor has the ability to exercise significant influence over the operating and financial decisions of the investee. The ability to exercise significant influence over the investee is mainly driven by the investor's ownership interest in the investee.

Associate and significant influence

The Board noted that paragraph 3 of IAS 28 defines an **Associate** as follows:

“An entity over which the investor has significant influence.”

Further, IAS 28 defines **Significant influence** as

“the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.”

The Board understands that evaluation of significant influence is framed in reference to “voting rights,” which can arise from instruments other than ordinary common shares.

The determination of whether an investment provides an investor with the ability to exercise significant influence over the operating and financial policies of an investee requires judgment considering the facts and circumstances associated with each investment. This determination is required on an ongoing basis.

Significant influence presumption

The Board would like to highlight that, in accordance with IAS 28, 20% of ownership is presumed to provide an investor with the ability to exercise significant influence over the

operating and financial policies of the investee.

Paragraph 5 of IAS 28 explains that if an entity holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

The Board noted that ability of an investor to exercise significant influence is principally derived from voting powers. Therefore, the presumption of significant influence is based on ownership of shares whose holders have present (and potential) voting rights.

The Board understands that consideration of all voting interests of an investee is solely for the purposes of determining whether the investor has presumptive significant influence over the operating and financial policies of the investor through its voting interests, without consideration of other factors that may indicate the ability to exercise significant influence (e.g., board representation).

An investor might be a relatively passive investor and still have the ability to exercise significant influence over an investee's operating and financial policies. That is, an investor does not need to actively exercise and demonstrate such ability. Therefore, it is not appropriate for an investor with an ownership interest of greater than 20% of the outstanding voting securities of an investee to overcome the presumption that it has the ability to exercise significant influence solely on the basis that it (1) has not historically exercised influence, and (2) does not intend to influence the investee in the future.

The Board also noted that, the general presumption of significant influence can be overcome if predominant evidence to the contrary exists. Therefore, an investor should consider the presumptive levels in evaluating whether or not it has the ability to exercise significant influence.

Indicators of significant influence

The Board noted that IAS 28 lists down various indicators which might evidence the existence of significant influence and should be considered by management in making its judgement on whether significant influence exists.

As outlined in IAS 28, an investor's ability to exercise significant influence over the operating and financial policies of an investee may also be indicated by any of the following:

- representation on the board of directors;
- participation in policy-making processes;
- material intra-entity transactions;
- interchange of managerial personnel; and
- technological dependency.

Relevant paragraph 6 of IAS 28 is reproduced below:

"The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

- a) representation on the board of directors or equivalent governing body of the investee;*
- b) participation in policy-making processes, including participation in decisions about dividends or other distributions;*

- c) *material transactions between the entity and its investee;*
- d) *interchange of managerial personnel; or*
- e) *provision of essential technical information.”*

Importantly, the Board based on the enquirer’s submission noted that that none of the other factors mentioned in paragraph 6 of IAS 28 are present in the investor-investee relationship.

However, the Board understands that existence of factor (b) above, i.e. participation policy-making processes needs to be carefully looked into.

In the submitted fact pattern, the Board understands that determination of significant influence of the Investor Company with its 29.72% shareholding in the Investee Company requires significant management judgement (as the Investor Company despite having 29.72% direct shareholding in the Investee Company) does not have representation on the Board of Directors of Investee Company.

The Board noted that IAS 28 does not provide any further explanations or conditions that should be considered to ascertain whether the participation in the policy making processes exists or not. The presumption that the investor has the ability to exercise significant influence over the investee’s operating and financial policies stands until overcome by predominant evidence to the contrary.

Indicators that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include the following:

- a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor’s ability to exercise significant influence.
- b. The investor and investee sign an agreement (such as a **standstill agreement**) under which the investor surrenders significant rights as a shareholder. (Under a standstill agreement, the investor usually agrees not to increase its current holdings. Those agreements are commonly used to compromise disputes if an investee is fighting against a takeover attempt or an increase in an investor’s percentage ownership. Depending on their provisions, the agreements may modify an investor’s rights or may increase certain rights and restrict others compared with the situation of an investor without such an agreement.)
- c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.
- d. The investor needs or wants more financial information to apply the equity method than is available to the investee’s other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.
- e. The investor tries and fails to obtain representation on the investee’s board of directors.

The Board understands that the list in the preceding paragraph is illustrative and is not exhaustive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee’s operating and financial policies. However, if any of these or similar circumstances exists, an investor with ownership of 20 percent or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee’s operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a

judgment.

The Board understands that none of the circumstances above are necessarily conclusive that the investor is unable to exercise significant influence over the investee's operating and financial policies. The investor should evaluate all facts and circumstances related to the investment when determining whether the presumption of significant influence over the investee is overcome.

In addition, the Board emphasizes the fact that when an investor has not exercised significant influence in the past or does not intend to exercise it in the future, it does not indicate that the general presumption of significant influence is overcome.

Significant influence through indirect relationship

The Board noted that Investor Company may be able to exercise significant influence through its indirect relationship with the investee company through the Parent Company, Mr. US and his sons. There can be informal arrangements in place between Mr. US who effectively controls Investor Company and Investee Company in concert with his sons who are directors in both the Investee Company and the Parent Company which controls the Investor Company.

Accordingly, the Board understands that participation of the Investor Company in the policy making of Investee Company may be made through such informal arrangements between Mr. US and his sons. In the context of the submitted fact pattern, following two points are pertinent in the assessment of whether any informal arrangements exist which evidence the participation of Investor Company in the policy making processes of the Investee Company:

- The sons of Mr. US, along with being directors of investee company, are also directors of the Parent Company whose subsidiary is the Investor Company. Accordingly, from a group perspective, the sons of Mr. US being charged with governance of entire group (i.e. Parent Company and its subsidiary Investor Company) are responsible for effective operations of the entire group. Therefore, it can be argued that the sons of Mr. US in their participation in the policy making processes of the Investee Company would give due consideration to interests of the Investor Company as they carry an indirect responsibility for its effective operations from a group perspective.
- Further, the enquirer in his subsequent communications submitted that at the time election of directors of Investee Company, Investor Company did not nominate any director to contest the election. This further enhances the possibility of existence of informal arrangements between Mr. US and his sons for participation in the policy making processes of the Investee Company. It is possible that Mr. US who effectively controls both the Investor and Investee Company may have concluded that the participation of Investor Company in the policy making of Investee Company can be done using his own controlling power and participation of his sons on its board of directors. Therefore, considering these factors, Investor Company might have decided not to nominate a director in the elections of Board of Directors of Investee Company.

Therefore, the Board understands that an evaluation of all facts and circumstances related to the investment is required to assess whether any of the factors exist in order to reach a judgment about whether the presumption of significant influence can be overcome. The fact that Investor (1) has not exercised its ability to influence Investee in the past and (2) does not intend to influence Investee in the future is not contrary evidence to overcome the presumption that Investor has the ability to exercise significant influence.

Conclusion

Based on the above discussion and analysis, the Board concluded that in the enquired scenario:

- a) The Investor Company and Investee Company are 'associated companies' within the meaning of section 2(4) of the Companies Act, 2017 as a single shareholder directly or indirectly holds or controls shares carrying not less than 20 percent voting power in both the companies;
- b) Investor Company and Investee Company are related parties in terms of IAS 24 as both the companies are effectively controlled by same person in concert with his close family members. Further, if management concludes that Investee Company is an associate of Investor Company in terms of IAS 28, then these would also be regarded as related parties under IAS 24 due to existence of investor-associate relationship.
- c) The determination of whether the Investee Company is an associate of Investor Company requires exercise of significant management judgement. In accordance with IAS 28, the Investor Company with 29.61% voting shareholding in the Investee Company is presumed to have the ability to exercise significant influence over the Investee Company, unless there is predominant evidence to the contrary to challenge this presumption. In this context, the predominant evidence to the contrary to the general presumption is needed to conclude that there is no ability to exercise significant influence.

The following is a non-exhaustive list of indicators that an investor may be unable to exercise significant influence:

- The investee's opposition to the investor's influence, as evidenced by lawsuits or complaints to regulatory authorities.
- The investor signs an agreement to surrender significant rights as a shareholder.
- Another group of shareholders has majority ownership, and operates it without regard to the investor's views.
- The investor is unable to obtain sufficient information to apply the equity method.
- The investor is unable to obtain representation on the investee's board of directors.

Accordingly, in accordance with IAS 28, management should consider and assess all facts and circumstances relating to the investment and relationship between Investor Company and Investee Company to determine whether the Investor Company has the ability to exercise significant influence on the Investee Company.

(October 9, 2019)

1.6 Clarification on applicability of International Valuation Standards on fair value measurements done under IFRS 13 *Fair Value Measurement*

Enquiry:

Our company made an investment (accounted for as financial asset at fair value through profit and loss) in a private company (a startup) having an e-commerce related business. In order to determine its fair value at year end, we have done its valuation based on discounted cash flow method as per IFRS 13 *Fair Value Measurement*.

But one of our senior management personnel objected on this and said it's not an appropriate method of valuation for startup businesses as per International Valuation Standards, as there are no historical cash flows to rely on.

My query is that

- (a) Whether the International Valuation Standards issued by International Valuation Standards Council are adopted by the ICAP; and
- (b) Whether management of company while preparing financial statements is compulsorily required to consider International Valuation Standards for the determination of fair values of assets and liabilities under IFRS 13.

Opinion:

Financial reporting framework

In the context of the submitted fact pattern, the Board noted that a company incorporated under the Companies Act, 2017 (the Companies Act) is required to prepare statutory financial statements in accordance with the requirements of the Companies Act.

Under the Companies Act, the financial reporting framework applicable to companies includes the International Financial Reporting Standards (IFRS) as notified by the Securities and Exchange Commission of Pakistan (SECP).

Further, the Board considered that IFRS Standards are issued by the International Accounting Standards Board (IASB). In Pakistan the IFRS are adopted by the SECP under the Companies Act.

The Board based on the background information and enquiries raised by enquirer considered that the company in the submitted fact pattern is preparing financial statements in accordance with IFRS.

IFRS 13 Fair Value Measurement

The Board considered that measurement of assets and liabilities for reporting in the financial statements is a part of overall preparation of financial statements.

Under the IFRS Standards, IFRS 13 *Fair Value Measurement* provides the framework for measurement of fair value of assets and liabilities. SECP has notified IFRS 13 for adoption under the Companies Act, therefore, it is applicable to a company preparing statutory financial statements under the Companies Act.

Paragraph 5 of IFRS 13 explains that this standard applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements, except for some specified exclusions.

Further, IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Paragraph 2 of IFRS 13 explains that this standard outlines a market based measurement, not an entity specific measurement. It adds that regardless of whether or not observable market transactions and information for an asset or liability is available or not, the objective in both cases is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at measurement date under current market conditions (i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

Paragraph B2 of the Application Guidance in IFRS 13 outlines the fair value measurement approach as follows (underline added and relevant portion reproduced only):

“A fair value measurement requires an entity to determine all the following:

(a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account).

(b) for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use).

(c) the principal (or most advantageous) market for the asset or liability.

(d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.”

(Emphasis is ours)

Valuation approaches

The Board understands that the valuation approaches are broad category of the valuation techniques, while a valuation technique refers to a specific technique such as a particular option pricing model.

IFRS 13 recognises three valuation approaches to measure fair value:

- a) Market approach
- b) Cost approach
- c) Income approach

Paragraph 62 of IFRS 13 outlines three valuation approaches, requiring an entity to use valuation techniques consistent with one or more of these approaches.

Relevant portion of paragraph 62 is reproduced below:

“Three widely used valuation techniques are the market approach, the cost approach and the income approach. The main aspects of those approaches are summarized in paragraphs B5-B11. An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value.”

(Emphasis is ours)

The main aspects of these valuation approaches, as explained in paragraphs B5 to B11 of IFRS 13 are explained below:

- a) **Market Approach:** The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.
- b) **Cost Approach:** The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.
- c) **Income Approach:** A fair value measurement using the income approach will reflect current market expectations about future cash flows or income and expenses.

The income approach converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

IFRS 13 paragraph B11 provides a number of examples of valuation techniques that are consistent with the income approach. However, the Board understands that the standard does not limit the valuation techniques that are consistent with the income approach to these examples; an entity may consider other valuation techniques.

The Board noted that present value techniques are included in the income approach. Paragraphs B13-B30 describe the use of present value techniques to measure fair value. The present value technique used to measure fair value will depend on facts and circumstances specific to the asset or liability being measured (e.g. whether prices for comparable assets or liabilities can be observed in the market) and the availability of sufficient data.

Valuation techniques

The Board would like to highlight that IFRS 13 requires an entity to use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value.

Further, the Board understands that the determination of the appropriate technique(s) to be applied requires significant judgement, sufficient knowledge of the asset or liability and an adequate level of expertise regarding the valuation techniques.

Relevant paragraph 61 of IFRS 13 is reproduced below:

“An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.”

The Board understands that IFRS 13 does not prioritise the use of one valuation technique over another. Instead, the standard establishes a fair value hierarchy for the inputs used in those valuation techniques, requiring an entity to maximize observable inputs and minimize the use of unobservable inputs.

Fair value hierarchy

With the objective to increase consistency and comparability in fair value measurements and related disclosures, the Board noted that IFRS 13 establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques used to measure fair value as follows:

- a) **Level 1 inputs** are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- b) **Level 2 inputs** are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- c) **Level 3 inputs** are unobservable inputs for the asset or liability.

The fair value hierarchy gives the highest priority to Level 1 inputs and the lowest priority to Level 3 inputs.

International Valuation Standards

The Board noted that the International Valuation Standards are issued by the International Valuation Standards Council.

The Board understands that International Valuation Standards pertain to the 'Valuers' profession. Adoption of the valuer profession related standards is not under ICAP's regulatory ambit.

IFRS Standards and International Valuation Standards

The Board understands that valuation experts are involved in various transactions and industries. For example, in the Oil and Gas industry, for which very important disclosures on the value of resources and reserves are not required by the IFRS. However, certain jurisdictions require professional valuation experts to assess these disclosures. Another example of use of valuation standards could be the option valuation models such as Black and Scholes that can be used for purposes of IFRS 2 *Share-based Payment* even though the specific method or model is not mandatorily specified in the IFRS Standards.

In context of fair value measurement, the Board noted that IFRS 13 does not require an entity to adopt a particular valuation method in given circumstances. The selection of most suitable valuation technique is a matter of management's judgement in the context of specific facts and circumstances of each case. However, any valuation technique selected must be consistent with the three broad valuation approaches outlined in IFRS 13.

The Board noted that IFRS 13 also does not obligate the application of International Valuation Standards for the determination of fair values under IFRS Standards.

Conclusion

Based on above discussion, the Board concluded that:

(a) The International Valuation Standards are issued by International Valuation Standards Council, and these standards pertain, in general, to the 'Valuers' profession. The adoption of professional standards relating to the Valuers is not under ICAP's regulatory ambit.

(b) IFRS 13 outlines that in measuring the fair value, those valuation techniques and approaches should be adopted that are appropriate and for which sufficient data is available to measure fair value. Accordingly, selection of the most suitable valuation technique is a matter of management's

judgement in the context of specific facts and circumstances of each case.

IFRS 13 prioritizes the inputs used in the application of valuation techniques. Based on this, the use of observable inputs should be maximized and the use of unobservable inputs be minimized but It does not prioritise the use of one valuation technique over another or require the use of only one technique.

IFRS 13 does not obligate the application of International Valuation Standard for the determination of fair values.

(January 27, 2020)

1.7 Application of IFRS 16 *Leases* in circumstances where entire lease payments are paid in advance

Enquiry

For the purposes of its power project, the Company (the "Lessee") has obtained a land on lease from Government (the "Lessor") under a lease agreement (the Agreement) for a period of 25 years. Term of the power project is also 25 years. As per the Agreement, the entity has paid all the lease rentals for 25 years in advance.

As all lease payments have been made in advance, your professional advice is required on following questions related to a lease arrangement:

- 1) How will we determine the lease liability?
- 2) How will we determine the finance cost?
- 3) What would be the value of the asset at initial recognition?

Opinion

The Board would like to highlight that IFRS 16 defines lease as *"a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration."*

IFRS 16 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

IFRS 16, through paragraph 5 allows recognition exemption (i.e. right of use of asset and corresponding lease liability) to short-term leases and low value leases.

Paragraph 5 is reproduced here under:

"A lessee may elect not to apply the requirements in paragraphs 22-49 to:

(a) short-term leases; and

(b) leases for which the underlying asset is of low value."

For availing the recognition exemption for low value assets, paragraph B4 of IFRS 16 explains that the assessment of whether an underlying asset is of low value is performed on an absolute basis, i.e. regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusions about whether a particular underlying asset is of low value.

However, IFRS 16 does not allow any recognition exemption for leases where entire lease payments have been made in advance and there is no lease liability for future lease payments.

Determination of lease liability

The Board noted that paragraph 26 of IFRS 16 outlines that at the commencement date, a lessee measures the lease liability as the present value of lease payments that have not been paid at that date.

Paragraph 26 of IFRS 16 states (underline is ours):

“At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee’s incremental borrowing rate.”

The Board understands that as per the above paragraph, only the remaining payments due should be used to measure the lease liability at lease commencement. In the submitted fact pattern, the enquirer has shared that the lease payments for entire lease term of the project site land have been paid in advance. Therefore, in terms of paragraph 26 of IFRS 16, the Board understands that the lease liability in the enquired scenario would be nil.

Determination of finance cost

The Board noted that paragraph 49 of IFRS 16 requires that in the statement of profit or loss and other comprehensive income, a lessee shall present finance costs on the lease liability separately from the depreciation charge for the right-of-use asset. In the submitted fact pattern, since no lease liability is recognised in respect of lease of project land, therefore, Board understands there will be no recognition of finance costs in respect of lease liability.

Determination of right-of-use asset

Paragraph 23 of IFRS 16 states that *“at the commencement date, a lessee shall measure the right-of-use asset at cost.”*

The constituents of cost as mentioned in paragraph 23 above, are outlined in paragraph 24 as follows:

“A fair value measurement requires an entity to determine all the following:

- (a) the amount of the initial measurement of the lease liability, as described in paragraph 26;*
- (b) any lease payments made at or before the commencement date, less any lease incentives received;*
- (c) any initial direct costs incurred by the lessee; and*
- (d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.”*

As discussed above, the Board considered that in the submitted fact pattern lease liability would be nil. Since the lease payments for the entire lease term have been paid in advance, the right of use asset in the submitted fact pattern should be measured at:

- Amount of lease payments made at or before the commencement date, i.e. lease payments paid in advance under paragraph 24(b) of IFRS 16;
- Any initial direct costs incurred by the company under paragraph 24(c) of IFRS 16;
- An estimate of costs to incurred by the company (if any) in restoring the project land to the condition required by the terms and conditions of the lease, under paragraph 24(d) of IFRS 16.

(February 07, 2020)

1.8 Recognition of membership fee in light of IFRS 15 *Revenue from Customers*, accounting of tenancy agreement in light of IFRS 16 *Leases* and disclosure of reimbursement expenses to a related party in light of IAS 24 *Related Party Disclosures*

Enquiry

We are a professional body for regulation and oversight of individual members practicing a particular profession. We are seeking your technical advice on following accounting matters:

A. Guidance on IFRS 15

Revenue from subscriptions received from members was recognized on receipt basis as IAS 18 *Revenue* did not contain any requirement regarding the performance obligations associated with the recognition of revenue. However, now IFRS 15 *Revenue from Contracts with the Customers* is applicable which requires that revenue should only be recognized based on the performance obligations. In view of this requirement, management has performed an assessment of the performance obligations in light of IFRS 15 and are of the view that the accounting policy regarding the subscriptions received from members does not require any change and the revenue should be recognized on receipt basis.

Management's conclusion to recognise revenue on receipt basis is based on the following assessment:

- A member pays his annual subscription in order to keep his membership active during the year. In case of non-payment of annual subscription, the membership is suspended. The annual subscription is kind of a charge to keep membership active and does not create any other performance obligation on part of the professional body.
- There is no legal or constructive obligation on the professional body to provide any kind of services to members on account of the annual subscription. Further, there is no defined timeline of any kind of performance obligation on part of the professional body as well. So, recognizing members' subscription as revenue on a periodic basis i.e. monthly/quarterly basis, does not seem logical.
- Becoming a member is not a compulsion. The annual subscription should be considered as a fee to remain associated with the professional body which give benefits to the member in the form of recognition. Once an individual's name appears in the list of members, the professional body's performance obligation is satisfied and revenue should be recognized.
- The membership subscription is given by members for entitlement to use the designation titles issued by the professional body to its members and recognition of being associated with a premier professional body. On payment of membership subscription, a member is considered to become an active member and is hence entitled to use the designation title, which is a form of performance obligation of the professional body.
- It should be noted if membership status of a member becomes inactive, the inactive member can still utilize the professional body's facilities. There is no mechanism to check whether the membership status of a member utilizing facilities is active or not. Therefore, the core objective of the subscription is the benefits derived by a member is the recognition of being associated with the professional body rather than any kind of service type performance obligation on part of the professional body.

B. Guidance on IFRS 16

The professional body as a lessee has entered into tenancy agreements for its offices and libraries in various cities of the country. Till the year ended June 30, 2019, the tenancy agreements were accounted for as operating leases with the rent expense being recognized as an expense and any prepaid rent being recognized as a current asset. With the adoption of IFRS 16, the distinction between finance and operating lease with regards to accounting by a lessee, has been eliminated.

In order to evaluate the implications of IFRS 16, management has performed an assessment of all the rental agreements to determine the termination rights of both the parties and the non-cancellable period of the lease.

The enquirer has shared its assessment of terms of lease agreements and has mentioned therein that:

- (a) All of its leased properties, except two leased properties in Hyderabad and Lahore, provide the right of both lessor and lessee to terminate the lease by giving less than 12 months' notice and without any penalty payment to other party or purchase option.
- (b) The lease agreements for leased properties in Hyderabad and Lahore provide lessees with a right to terminate the lease by giving 3 months' prior notice without any penalty. However, the lessor (property owner) will have the same termination option only after expiry 5 years from commencement of lease.

Management is of the view that where agreement provides the cancellation rights to both the parties and the non-cancellable period is less than 12 months, then the lease agreement will not fall under the scope of IFRS 16 as it will be considered as a "Short term Lease". In cases where either the lessee or the lessor do not have the termination rights and the non-cancellable period is more than 12 months, the agreement would fall under the scope of IFRS 16.

C. Guidance on IAS 24

In the Financial Statements for the year 2019, "**Reimbursement of Expenses**" to the supervisory board members of the professional body are considered as a related party transaction and therefore, disclosed as per the requirements of IAS 24 *Related Party Disclosures*. We understand that supervisory board members are related party because they have significant influence over the professional body and any kind of transaction with them is to be considered as a related party transaction.

Please guide on following matters:

- A. Whether management's assessment and conclusion regarding the recognition of membership subscription as income on receipt basis is appropriate as per IFRS 15?
- B. Whether management's assessment and conclusions on the lease-terms under various tenancy agreements are appropriate as per IFRS 16? and
- C. Whether management's assessment and conclusion on the disclosure of reimbursement of expenses to the supervisory board members in course of official duties is appropriate as per IAS 24?

Opinion

A. Recognition of membership fee under IFRS 15

The Board considered that the professional body is regulating the profession as a statutory institution formed and operating under its statute passed by the Parliament of Pakistan.

The statute governing the professional body states that:

“All persons whose names are entered in the Register at the commencement of this Ordinance and all persons who may hereafter have their names entered in the Register under the provisions of this Ordinance, so long as they continue to have their names borne on the said Register, are hereby constituted a body corporate by the name of the Institute, and all such persons shall be known as members of the Institute.”

(Emphasis is ours)

The Board noted that under the statute, the professional body receives subscriptions from its members. These subscriptions mainly include:

- Admission fee
- Annual membership fee
- Life-time membership fee
- Membership restoration fees and prior period annual fees

The Board noted that, under the principle outlined in paragraph 31 of IFRS 15, revenue recognition against the various types of subscriptions from members would be based on the professional body's fulfilment of its performance obligation(s) related to the particular type of fee.

Paragraph 31 of IFRS 15 is reproduced below:

“An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.”

IFRS 15 through paragraph 22 explains that a performance obligation is a promise to deliver a good or provide a service to the customer.

The Board considered that, for the identification of performance obligations, IFRS 15 requires an entity to assess the promised goods and services in a contract with a customer. Having assessed those promised goods or services, an entity then identifies as a performance obligation each promise to transfer (a) a good or service (or a bundle of goods or services) that is distinct; or (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

IFRS 15 in paragraph 10 explains that a contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations is a matter of law. The criteria that need to be in place to establish that a contract exists are intended to demonstrate that there is a valid and genuine transaction between an entity and its customer and that the parties to the contract have enforceable rights and obligations that will have economic consequences.

Paragraph 24 of IFRS 15 explains that performance obligation(s) can be explicit (i.e. identified in the entity's contract with the customer) or implicit (implied by the entity's customary

business practices, policies and statements).

Paragraph 25 of IFRS 15 outlines that performance obligations do not include the activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer.

Further, paragraph B49 of IFRS 15 states that to identify performance obligations in contracts in which an entity charges a non-refundable upfront fee, the entity assesses whether the fee relates to the transfer of a promised good or service. IFRS 15 outlines that in many cases, even though a non-refundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer.

In accordance with paragraph B40 of IFRS 15, when an entity grants the customer an option to acquire additional goods or services, that option is a performance obligation under the contract if it provides a material right that the customer would not receive without entering into that contract. Both quantitative and qualitative factors should be assessed to determine whether a non-refundable up-front fee provides a material right to the customer.

In context of fulfillment of the performance obligations, an entity in accordance with paragraph 32 of IFRS 15, at the inception of the contract, determines whether it satisfies each performance obligation over time or at a point in time. Accordingly, revenue is either recognised over time in accordance with paragraph 35 of IFRS 15 or recognised at a point in time in accordance with paragraph 38 of IFRS 15.

Relevant paragraph 32 is as under:

“For each performance obligation identified in accordance with paragraphs 22-30, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 35-37) or satisfies the performance obligation at a point in time (in accordance with paragraph 38). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.”

Paragraph 35 of IFRS 15 provides guidance about the satisfaction of performance obligation over time, it states:

“An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

- a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;*
- b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced;*
- c) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.”*

(Emphasis is ours)

Paragraph 38 of IFRS 15 provides guidance about the satisfaction of performance obligation at a point in time, it states:

“If a performance obligation is not satisfied over time in accordance with paragraphs 35-37, an entity satisfies the performance obligation at a point in time.....”

(Emphasis is ours)

In context of the transfer of control, the Board noted that a good or service is transferred to a customer when the customer obtains control of it. ‘Control’ refers to the customer’s ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. It also includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. Potential cash flows that are obtained either directly or indirectly - e.g. from the use, consumption, sale or exchange of an asset - are benefits of an asset.

In the submitted fact pattern, the Board understands that obtaining membership of the professional body is voluntary for an individual who becomes eligible to be admitted as a member. In accordance with the statute of the professional body, a member is required to pay admission and annual membership fees to the professional body.

Based on the above guidance of IFRS 15, a brief discussion and conclusion on revenue recognition of various types of fees received from members is as under:

Admission fee

The Board noted that professional body under the statutory provisions does not promise to transfer any good or service to the member other than the service of being entered in the register of members.

Paragraph 25 of IFRS 15 states that performance obligations include only those activities undertaken that transfer a good or service to a customer.

Paragraph B49 of IFRS 15 discusses the requirement specifically in relation to contracts for which an entity charges a customer a non-refundable upfront fee at or near contract inception. Usually, the upfront fee does not result in the transfer of a distinct good or service to the customer and therefore is not treated as a separate performance obligation.

The Board understands that admission fee from a member is a non-refundable up-front fee. Under the professional body’s statute, along-with the admission fee, first year membership fee is also required to be paid for entering his/her name in the register of members. After admission, the professional body is entitled to receive annual membership fee for entering the name of the member in the register in subsequent years.

Therefore, in terms of IFRS 15, the Board understands that against the admission fee, the professional body does not transfer any service to the member. The payment of admission fee entitles a member with a material right to obtain and renew annual membership. This fee can be construed similar to an entrance fee, legally enabling a member to initially obtain and in subsequent years renew the membership, after paying annual membership fee.

In accordance with paragraph B49 of IFRS 15, the Board concluded admission fee should be recognised as revenue over the estimated period for which the member will have the right to obtain and renew annual membership services.

Annual membership fee

The Board understands that the professional body, against the annual membership fee, is obligated to enter the name of a member in the register, in accordance with the provisions of its statute.

The professional body admits and enters the name of a member in the register on the payment of admission and membership fees as prescribed in its statute. After admission of a member in the register, in subsequent years, the professional body is entitled to receive annual membership fee for entering the name of the member in the register.

Conversely, in case of non-payment of prescribed annual fee by a member, the professional body can remove the name of a member from the register, under relevant section of its statute.

Paragraph 24 of IFRS 15 explains that performance obligation(s) can be explicit (i.e. identified in the entity's contract with the customer) or implicit (implied by the entity's customary business practices, policies and statements).

In context of annual membership fee, the Board noted that under the statute of the professional body:

- The professional body is legally obligated to enter the name of a member in the register, while it's legal right is to receive non-refundable annual membership fee within the specified time; and
- A member is legally obligated to pay non-refundable annual membership fee within the specified time, while member's legal right is to have his/her name entered in the professional body's register of members.

Based on the above, the Board understands that professional body's performance obligation against annual membership fee is satisfied by entering the name of a member in the register. There is no other performance obligation of the professional body in consideration of the annual membership fee.

The Board understands that the annual membership fee is non-refundable, and the performance obligation (i.e. entering the name of a member in the register) is fulfilled at the time this activity is performed by the professional body in accordance with the relevant provisions of its statute. Therefore, fulfilling the rights and obligations of the professional body. In accordance with IFRS 15 paragraph 31 read together with paragraph 38, recognition of annual membership as income would be at a point in time, based on above noted performance obligation of the professional body.

Life membership fee

The Board noted that under the statute of the professional body, a member can pay one-time membership fee on attaining the specified age and meeting certain other requirements. The life membership fee enables a member to become life time member of the professional body. The life-time membership fee would result in provision of membership service to a member for the rest of his/her life.

The Board understands that in principle, the performance obligation against the life membership fee is to enter the name of the member in the register, annually, over the life of a member.

The Board concluded that life membership fee should be recognised as revenue over the estimated period for which the member will obtain the service against it, based on the mechanism established for the recognition of income against annual membership fee.

Membership restoration fees and prior period annual fees

The Board noted that payment of fees in respect of restoration of membership including prior

years defaulted membership fees (i.e. of periods during which the membership was suspended) results in restoration of a member's name in the register. The restoration fees do not result in any membership service related to the prior years.

The Board concluded that restoration fees and prior year defaulted annual membership fees are in the nature of a penalty for not continuing membership of the professional body. The membership restoration fees (i.e. prior year membership fee and additional charges) should be recognised at a point in time i.e. upon restoring the name of a member in the register.

B. Accounting of tenancy agreements under IFRS 16

The Board noted that IFRS 16 defines lease as “a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.”

The identification of a lease includes assessment of the ‘period of the time’ (i.e. Term of the lease contract).

Paragraph 9 of IFRS 16, reproduced hereunder, states that:

“At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9-B31 set out guidance on the assessment of whether a contract is, or contains, a lease.”

(Emphasis is ours)

The Board noted that in context of the enquirer's question, the fundamental point is to assess lease terms of the professional body's tenancy agreement, in accordance with IFRS 16. This assessment would provide guidance on whether the leases are short term under IFRS 16.

IFRS 16, through paragraph 5(a) allows recognition exemption (i.e. right of use asset and corresponding lease liability) to short-term leases.

Paragraph 5 is reproduced here under:

“A lessee may elect not to apply the requirements in paragraphs 22-49 to:

(a) short-term leases; and

(b) leases for which the underlying asset is of low value.”

(Emphasis is ours)

Further paragraph 8 outlines that:

“The election for short-term leases shall be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. The election for leases for which the underlying asset is of low value can be made on a lease-by-lease basis.”

Paragraph 6 of IFRS 16 adds that if a lessee elects not to apply the requirements of IFRS 16 to short-term leases, the lessee shall recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis.

The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

The IASB while providing underlying reason for allowing exemption to short-term leases in paragraph BC87 and BC89 noted that:

"The IASB concluded that the benefits of requiring a lessee to apply all of the requirements in IFRS 16 to short-term leases do not outweigh the associated costs....."

"The IASB concluded that, even with simplified measurement requirements, the benefits of requiring a lessee to recognise right-of-use assets and lease liabilities for short-term leases would not outweigh the associated costs. Consequently, paragraph 5(a) of IFRS 16 permits a lessee to elect not to apply the recognition requirements to short-term leases. Instead, a lessee can recognise the lease payments associated with short-term leases as an expense over the lease term, typically on a straight-line basis. The IASB decided that this choice should be made by class of underlying asset."

Short-term leases are defined in IFRS 16 as "a lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease."

In the Basis of Conclusion of IFRS 16 (paragraphs BC91-BC97), IASB explained the background to the definition of short-term lease definition, and paragraph BC93 is reproduced hereunder:

"Instead, the IASB decided to expand the short-term lease exemption by making the determination of duration of short-term leases consistent with the determination of lease term, thus considering the likelihood of extension options being exercised or termination options not being exercised (see paragraphs BC152-BC159). Accordingly, IFRS 16 defines a short-term lease as a lease that, at the commencement date, has a lease term of 12 months or less."

(Emphasis is ours)

IFRS 16 in paragraph 18 defines 'lease term' as the non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

- (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

Paragraph B34 explains that in determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

"In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty."

(Emphasis is ours)

As explained in BC156, in the IASB's view, the lease term should reflect an entity's reasonable expectation of the period during which the underlying asset will be used because that approach provides the most useful information.

Paragraph BC129 outlines, IASB's thought process on economic substance of lease contract.

"The IASB considered whether applying enforceability to leases in this way might encourage entities to add a clause to a lease that does not have economic substance, for example, stating that the lease could be cancelled at any point, knowing that, in practice, it would not be cancelled. However, the IASB is of the view that such clauses are unlikely to be added because there often is an economic disincentive for either the lessor or lessee to agree to their inclusion. For example, if a lessor has priced a contract assuming that the lessee will not cancel the contract, including such a clause would put the lessor at risk of being exposed to higher residual asset risk than had been anticipated when pricing the contract, which would be an economic disincentive for the lessor. Conversely, if the lessor has priced the contract assuming that the lessee will or may cancel the contract, the lessee would be likely to have to pay higher rentals to compensate the lessor for taking on more residual asset risk. Those higher rentals would be an economic disincentive for the lessee, if it does not intend to cancel the contract."

(Emphasis is ours)

Further, paragraph B35 outlines the requirement to consider the termination rights of lessee in calculating the lease-term. This paragraph adds that if only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease.

Paragraph B35 is reproduced hereunder:

"If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease."

Based on the above (paragraph B34 of IFRS 16), the Board considered that the lease term assessment also requires consideration of the *"with no more than an insignificant penalty"*. However, the Board noted that there is no further discussion in IFRS 16 on what constitutes an insignificant penalty and hence, it is a matter of judgement considering all relevant facts and circumstances of each case.

The Board also considered that IFRS Interpretations Committee (IFRIC) in its draft agenda decision issued in November 2019 highlighted that an entity needs to make a holistic assessment of lease term that considers all relevant facts and circumstances.

Applying this context, IFRS 16 requires consideration of contracts economics when determining the enforceable period and ultimately term of a lease. In other words, a broader reading of the word penalty is consistent with this context, whereas a narrow reading would be inconsistent with this context and would risk undermining the economic perspective sought by the International Accounting Standards Board (IASB).

Accordingly, the Board understands that the use of term 'penalty' in paragraph B34 indicates

that it means something different from only contractual termination payments, and in this case refers to any economic penalty (that is more than insignificant) that might arise from termination.

Such factors may include:

- Contract-based factors (e.g., the terms and conditions of termination in the contract);
- Asset-based factors (e.g., impact of significant leasehold improvements, impact of lessor's renovations);
- Market-based factors (e.g., costs associated with terminating versus separately buying a similar asset or entering into a new lease for a similar asset);
- Entity-based factors (e.g., the lessee's intent and past experience with lessor).

Paragraph 19 of IFRS 16 requires that in assessing whether a lessee is reasonably certain to exercise an option to extend a lease, or not to exercise an option to terminate a lease, an entity shall consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease.

This is further described in paragraphs B37-B40 of IFRS 16, that at commencement date an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option.

Examples of factors to consider include, but are not limited to:

- (a) contractual terms and conditions for the optional periods compared with market rates, such as:
 - i. the amount of payments for the lease in any optional period;
 - ii. the amount of any variable payments for the lease or other contingent payments, such as payments resulting from termination penalties and residual value guarantees; and
 - iii. the terms and conditions of any options that are exercisable after initial optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
- (b) significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;
- (c) costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's needs, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location;
- (d) the importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset, the location of the underlying asset and the availability of suitable alternatives; and
- (e) conditionality associated with exercising the option (i.e. when the option can be exercised

only if one or more conditions are met), and the likelihood that those conditions will exist.

The Board finds it relevant to highlight here that an option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments, an entity shall assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease. The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.

A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if a lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, the lessee shall consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets.

In accordance with IFRS 16, the leases whose lease term is determined to be more than 12 months, accordingly do not qualify for short term lease exemption outlined in paragraph 5 of IFRS 16, the recognition and measurement under new lessee accounting model would be as under.

In accordance with paragraphs 23-24 of IFRS 16, the lessee shall recognise a right-of-use asset and a lease liability at the commencement date. The lessee shall measure the right-of-use asset at cost. The cost of the right-of-use asset shall comprise of:

- (a) the amount of initial measurement of the lease liability, as described in paragraph 26 of IFRS 16;
- (b) any lease payments made at or before the commencement date, less any lease incentives received;
- (c) any initial direct costs incurred by the lessee; and
- (d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

The lease liability in (a) above shall be measured at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

Interest on the lease liability in each period during the lease term shall be the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability.

In the submitted fact pattern, the Board noted the enquirer's submission about its

assessment of terms of lease agreements of lessee's leased properties that:

- (a) All of its leased properties, except two leased properties in Hyderabad and Lahore, provide the right of both lessor and lessee to terminate the lease by giving less than 12 months' notice and without any penalty payment to other party or purchase option.
- (b) The lease agreements of Hyderabad and Lahore properties, provide Lessee's a right to terminate the lease by giving 3 months' prior notice without any penalty. However, the lessor (property owner) will have the same termination option only after expiry 5 years from commencement of lease.

The Board understands that for determination of the enforceable/non-cancellable lease term of these properties, it needs to be assessed at the lease commencement date that whether it is reasonably certain that the professional body will not exercise the termination option before the lessor's right to terminate becomes exercisable.

The Board further understands that application of IFRS 16 on the fact pattern submitted by the enquirer would be under following two (I and II) broad categories:

- I. The tenancy agreement having a tenor of more than 12 months would be short-term lease if the lease arrangement contains:
 - Termination rights - Both Lessee and lessor have right to terminate the tenancy agreement at any time after the lease commencement date, without permission of the other party.
 - Notice period - A notice of termination can be served any time after the lease commencement date, and the notice period does not exceed 12 months. It is 3 months in the professional body's tenancy agreements.
 - Termination and economic penalties - There are no significant termination penalties under the tenancy agreement. Further, there are no significant economic penalties of termination.

Under this category of tenancy agreements of the professional body, the Board noted that though the lease agreement is signed for a tenor of more than 12 months, however, the lessee and lessor's rights to terminate the lease at any time (e.g. by serving a 3 months notice and without consent of the other party) makes such contracts enforceable for 3 months only, provided there are no significant penalties.

Applying above guidance of IFRS 16 on the submitted fact patterns (related to tenancy agreements and categorized under I, above), the Board concluded that:

- (a) **After the lease commencement date, lessee can terminate the lease by serving a 3 months' notice. Therefore, lessee does not have an obligation to make lease payments past the notice period.**

On the other hand, lessor also has the right to terminate the lease by serving 3 months' prior notice, after the lease commencement. Thereby limiting professional body's ability to extend the lease past the notice period.

- (b) **Besides these termination rights and length of notice period, as per paragraph B34 of IFRS 16, lessee's assessment of the contractual penalties and the economic penalties of lease termination are also critical to the determination of the lease term.**

- (c) If the professional body concludes that the lease agreement is enforceable beyond the notice period (i.e. 3 months), then it would be required to assess the time period it is reasonably certain not to exercise the option to terminate the lease.
- II. A tenancy agreement having tenor of more than 12 months could be long-term lease if the lease arrangement provides:
- Termination rights - Both lessee and lessor have the rights to terminate the arrangement. However, under the submitted fact pattern, the lessor can exercise this right after 5 years of the lease agreement date. On the other hand, lessee has the right to terminate the arrangement at any time after the agreement signing.
 - Notice period - Both lessee and lessor can exercise the termination right by serving at least 3 months' prior notice.
 - Termination and economic penalties - There are no significant termination penalties under the lease agreement. Further, there are no significant economic penalties of termination.

Under this category of tenancy agreements, in accordance with paragraph B35 of IFRS 16, the lease term would include the periods covered by an option to terminate the lease, if lessee is reasonably certain not to exercise that (termination) option.

Applying above guidance of IFRS 16 on the fact patterns shared by the enquirer (related to tenancy agreements and categorized under II, above), the Board concluded that:

- (a) Both lessee and lessor can terminate the tenancy agreement at any time without consent of the other, only by serving a prior notice. However, lessor has the right to terminate the tenancy agreement after 5 years of the lease agreement date. On the other hand, at any time lessee can terminate by serving 3 months' prior notice. Therefore, contractually it does not have an obligation to make lease payments past that period.
- (b) In accordance with paragraph B35 of IFRS 16, lessee would be required to assess when it would exercise the termination option. In the determination of the exercise of termination option, management should make an assessment of the economic penalty under the termination of the lease arrangement.
- (c) In case, lessee assesses that it will not exercise its termination option before lessor's right to terminate the lease becomes exercisable (i.e. 5 years of the lease agreement date), then the lease term would be as follows:
- i. The period over which lessor has no right to terminate the lease; and
 - ii. Notice period to be given by lessor to lessee for termination of lease.

C. Disclosure of reimbursement of expenses to Board members under IAS 24

The Board considered that a related party is defined in IAS 24 as (relevant portion reproduced only):

“A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the ‘reporting entity’).

- (a) *A person or a close member of that person's family is related to a reporting*

entity if that person:

- (i) has control or joint control of the reporting entity;
- (ii) has significant influence over the reporting entity; or
- (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.....”

IAS 24 defines the term key management personnel as “those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.”

The Board noted that under the statute of the professional body, the supervisory board is collectively entrusted with the responsibility of management of the professional body’s affairs, including the responsibility for policy-making processes.

An individual supervisory board member is a person having authority and responsibility for planning, directing and controlling the activities of the professional body. Therefore, a supervisory board member is a related party of the professional body being a member of its key management personnel

Paragraph 9 of IAS 24 explains the related party transaction as a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.

Under paragraph 18 of IAS 24, if an entity has related party transactions during the periods it shall disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements.

At a minimum, disclosures shall include:

- (a) the amount of the transactions;
 - (b) the amount of outstanding balances, including commitments, and:
 - i. their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
 - ii. details of any guarantees given or received;
 - (c) provisions for doubtful debts related to the amount of outstanding balances; and
 - (d) the expense recognised during the period in respect of bad or doubtful debts due from related parties.
2. Further, the Board noted that under paragraph 17 of IAS 24, an entity is required to disclose key management personnel compensation in total and for each of the specified categories.

IAS 24 defines compensation as all employee benefits (as defined in IAS 19 *Employee Benefits*) including employee benefits to which IFRS 2 *Share-based Payment* applies. Employee benefits, as defined in IAS 19, are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect of the entity. Compensation includes:

- (a) short-term employee benefits, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if

payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

- (b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;
- (c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;
- (d) termination benefits; and
- (e) share-based payment.

The Board noted that in the submitted fact pattern i.e., the reimbursement of actual expenses to a supervisory board member do not result in the transfer of resources, services or obligations between the professional body and the supervisory board member.

Accordingly, the Board understands that reimbursement of actual expenses by a supervisory board member also do not fall under the key management personnel compensation as required to be disclosed under paragraph 17 of IAS 24.

The supervisory board member is merely acting as an intermediary in the settlement of the professional body's expenditure. In substance such transactions are between the professional body and the third party service providers.

Further, other entities also reimburse expenditures (related to the official expenditures incurred on behalf of the entity) to the director, key management personnel etc. However, such transactions are not disclosed in the financial statements of the entities.

Therefore, the Board concluded that, in terms of IAS 24, transactions do not require disclosure in financial statements if these reflect:

- (a) Payment of expenses by supervisory board members on behalf of the professional body, in connection with their official duties; and**
- (b) Reimbursement of these amounts by the professional body to the supervisory board members.**

(February 12, 2020)

1.9 Revenue recognition under IFRS 15 in the circumstances where customer has no intention and ability to pay consideration

Enquiry:

The enquiry pertains to a public unlisted company incorporated in Pakistan under the repealed Companies Ordinance, 1984 engaged in terminal operations (the Company).

The Company signed an 'Implementation Agreement' (IA) with a government authority (the Customer) for provision of infrastructure facility for berthing and handling of furnace oil (FO) for a period of thirty years. Under the agreement, the Company has the exclusive concession right and license to design, construct, own, operate, manage and maintain the terminal on Build, Own and Operate (BOO) basis. Hence, IFRIC 12 *Service Concession Arrangements* does not apply in this case.

The berthing and oil handling facilities are provided to Oil Marketing Companies (OMCs), on behalf of the customer, based on schedule agreed with Oil Companies Advisory Council (OCAC). These services are also provided to OMCs directly approaching the Company. Therefore, the operation i.e. handling of product is not controlled/directed by the Customer and does not fall under the category of lease under the provisions of IFRS 16 *Leases*.

Under the IA, the Company is entitled to monthly revenue calculated by multiplying fixed quantity of FO by a specified rate. The Customer is liable to make payment to the Company for oil handling charges at the beginning of each month. The throughput charges receivable from the Customer are fixed, regardless of the actual quantity of FO handled at the Company's terminal. This fixed amount is also secured in the form of Government of Pakistan (GoP) guarantee. In case of shortfall in throughput quantity, a claim is lodged with the GoP for payment under the guarantee provided in the IA.

During the financial year (FY) 2018-19, a ban was imposed by the GoP on import of FO, resulting in a decline in throughput handling of FO at the Company's terminal. Consequently, the quantity handled at the Company's terminal during FY 2018-19 significantly declined in comparison to the guaranteed annual quantity and has completely dried up during the current FY 2019-20. In this context, it is pertinent to mention here that as per past practice and factual position, the customer makes payment to the Company after recovering the handling charges (including government authority charges/royalty) from the relevant OMC's importing FO at the Company's terminal. Since, no FO is being imported and handled at the Company's terminal, the customer is unable to make payments to the Company under IA.

As per IFRS 15, an entity shall account for revenue from a contract only when it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. As the customer has neither the intent nor the ability to pay the monthly dues, the Company intends to cease revenue recognition under the IA and invoke the GoP guarantee for recovery of dues. Please advise.

Opinion:

Criteria for a contract with a customer under IFRS 15

The Board noted that paragraph 9 of IFRS 15 outlines the criteria which must be satisfied for a contract with a customer to be accounted for under IFRS 15 as follows (underline is added):

"An entity shall account for a contract with a customer that is within the scope of this Standard only when all of the following criteria are met:

- (a) *the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations;*
- (b) *the entity can identify each party's rights regarding the goods or services to be transferred;*
- (c) *the entity can identify the payment terms for the goods or services to be transferred;*
- (d) *the contract has commercial substance (i.e. the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and*
- (e) *it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession.*

The Board noted the above paragraph 9(e) highlights that an entity only applies the revenue recognition guidance of IFRS 15 when it is 'probable' that the entity will collect the consideration that it is entitled to in exchange for the goods or services that it transfers to the customers. The term probable has been defined as 'more likely than not'. Further, the objective of the collectability assessment is to determine whether there is a substantive transaction (i.e. a valid contract) between the entity and a customer. The entity's assessment of this probability should reflect both the customer's ability and its intent to pay as amounts become due.

In accordance with paragraph BC32 of IFRS 15, the Board considered that the assessment of whether a contract exists for the purpose of applying the standard focuses on the enforceability of rights and obligations based on the relevant laws, legal precedent and regulations, rather than the form of the contract (oral, implied or written). Paragraph BC32 reproduced, hereunder:

"The definition of a contract emphasises that a contract exists when an agreement between two or more parties creates enforceable rights and obligations between those parties. The boards noted that the agreement does not need to be in writing to be a contract. Whether the agreed-upon terms are written, oral or evidenced otherwise (for example, by electronic assent), a contract exists if the agreement creates rights and obligations that are enforceable against the parties. Determining whether a contractual right or obligation is enforceable is a question to be considered within the context of the relevant legal framework (or equivalent framework) that exists to ensure that the parties' rights and obligations are upheld. The boards observed that the factors that determine enforceability may differ between jurisdictions. Although there must be enforceable rights and obligations between parties for a contract to exist, the boards decided that the performance obligations within the contract could include promises that result in the customer having a valid expectation that the entity will transfer goods or services to the customer even though those promises are not enforceable."

Assessment of the customer's ability and intention to pay consideration

The Board noted that paragraph BC42 of IFRS 15 explains that the International Accounting

Standards Board (IASB) included this criterion in paragraph 9(e) of IFRS 15 (which acts like a collectability threshold) because IASB concluded that the assessment of a customer's credit risk was an important part of determining whether a contract is valid. Furthermore, the IASB (as well as FASB, US) decided to include this criterion as a consequence of their decision that customer credit risk should not affect the measurement or presentation of revenue.

Further, paragraph BC43 adds that IASB decided that a collectability threshold is an extension of the other requirements in paragraph 9 of IFRS 15 on identifying the contract.

In essence, the other criteria in paragraph 9 require an entity to assess whether the contract is valid and represents a genuine transaction. The collectability threshold is related to that assessment because a key part of assessing whether a transaction is valid is determining the extent to which the customer has the ability and the intention to pay the promised consideration. In addition, entities generally only enter into contracts in which it is probable that the entity will collect the amount to which it will be entitled.

The Board noted that paragraph BC45 explains that the entity assesses whether it is probable of collecting the amount of consideration by considering both of the following:

(a) **the ability (i.e. the financial capacity)** of the customer to pay the amount of consideration to which the entity will be entitled in exchange for the goods or services transferred.

(b) **the customer's intention to pay that amount.** The IASB observed that an assessment of the customer's intention would require an entity to consider all of the facts and circumstances, including the past practice of that customer or customer class. The boards noted that this assessment should be made on the assumption that the amount will be due (i.e. the corresponding performance obligation will be satisfied and the consideration is not subject to further variability that might affect the entity's entitlement to that consideration).

Further, paragraph BC46 highlights that an entity should assess only the consideration to which it will be entitled in exchange for the goods or services that will be transferred to a customer. Therefore, if the customer were to fail to perform as promised and consequently the entity would respond to the customer's actions by not transferring any further goods or services to the customer, the entity would not consider the likelihood of payment for those goods or services that would not be transferred.

Paragraph BC45 is reproduced hereunder:

"In determining whether it is probable that an entity will collect the amount of consideration to which the entity will be entitled, an entity might first need to determine the amount of consideration to which the entity will be entitled. This is because, in some circumstances, the amount of consideration to which an entity will be entitled may be less than the price stated in the contract. This could be because the entity might offer the customer a price concession (see paragraph 52 of IFRS 15) or because the amount of consideration to which an entity will be entitled varies for other reasons, such as the promise of a bonus. In either of those circumstances, an entity considers whether it is probable that the entity will collect the amount of consideration to which it will be entitled when the uncertainty relating to that consideration is resolved. The entity assesses whether it is probable of collecting that amount by considering both of the following:

(a) the ability (i.e. the financial capacity) of the customer to pay the amount of consideration to which the entity will be entitled in exchange for the goods or services transferred.

(b) the customer's intention to pay that amount. The boards observed that an

assessment of the customer's intention would require an entity to consider all of the facts and circumstances, including the past practice of that customer or customer class. The boards noted that this assessment should be made on the assumption that the amount will be due (i.e. the corresponding performance obligation will be satisfied and the consideration is not subject to further variability that might affect the entity's entitlement to that consideration)."

Further, the Board noted that paragraph 13 of IFRS 15 states that if a contract with a customer meets the criteria in paragraph 9 at contract inception, an entity shall not reassess those criteria unless there is an indication of a significant change in facts and circumstances. For example, if a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer.

Paragraph 14 adds that if a contract with a customer does not meet the criteria in paragraph 9, an entity shall continue to assess the contract to determine whether the criteria in paragraph 9 are subsequently met.

The collectability threshold is applied to the amount to which the entity expects to be entitled in exchange for the goods and services that will be transferred to the customer, which may not be the stated contract price. The assessment considers:

- the entity's legal rights;
- past practice;
- how the entity intends to manage its exposure to credit risk throughout the contract; and
- the customer's ability and intention to pay.

The collectability assessment is limited to the consideration attributable to the goods or services to be transferred to the customer for the non-cancellable term of the contract. For example, if a contract has a two-year term but either party can terminate it after one year without penalty, then an entity assesses the collectability of the consideration promised in the first year of the contract (i.e. the non-cancellable term of the contract).

Assessment of the customer's ability and intention in the enquired scenario

In the submitted fact pattern, the Board based on the enquirer's submission noted that the Company has concluded in its assessment that the Customer neither have intention nor the ability to pay the fixed monthly throughput charges (consideration) to the Company under the IA based on the following:

- Under the IA, the Company's performance obligation is to operate and maintain infrastructure facility for berthing and handling of FO for OMCs. In consideration, the Customer pays fixed monthly charges to the Company. The Customer in its separate contracts with OMCs charges royalty and oil handling charges to them for use of the Company's facility and company does not have any direct performance obligation towards OMCs as it is not a party to these contracts.
- Due to the ban imposed by the GoP on import of FO, OMCs are no longer using the Company's facility for handling of FO, and therefore, customer is not earning any revenue from OMCs under its separate contracts. However, the Company is operating and maintaining the facility in line with its performance obligation under the IA and as such is entitled to the monthly fixed payment from the customer irrespective of the ban imposed by the GoP.
- As per the past practice and factual position, the Customer used to make monthly

payments to the Company after recovering the handling charges from OMCs under its separate contracts with them. However, subsequent to ban imposed by the GoP, the Customer is unable to generate the funds from OMCs to settle its performance obligation towards the Company.

Accordingly, the Board noted that in the management's assessment it is not probable that it would be able collect the consideration for maintenance and operation of oil terminal from the Customer. Therefore, the Company believes that it should not recognise any further revenue in its financial statements for operation and maintenance of oil terminal.

The Board would like to emphasize that assessment of customer's intent and ability to pay consideration requires the management to consider all the relevant facts and circumstances, and involves significant judgement. Accordingly, as a part of its assessment, the management should also consider legal aspects of customer's performance obligation to pay fixed monthly charges under the IA in the context of the ban imposed by the GoP on import of FO. This is important because the ban imposed by the GoP might not have been foreseen at the time of execution of the IA between the Company and the Customer, and therefore, it is important to establish that under IA the Customer is still liable to pay monthly fixed charges to the Company despite the ban imposed on import of FO by the GoP.

Further, the Board noted that the enquirer has also submitted that the payments to the Company by the Customer are secured by the GoP guarantee. In the event of any shortfall in the actual throughput capacity, company lodges a claim with the GoP under the guarantee provided in the IA for recovery of shortfall.

The Board understands that the assessment of customer's ability to pay the consideration also includes the probability of collection from the protective recourses available to the entity in the event that the customer defaults in the payment of consideration. In the enquired fact pattern, the assessment of whether it is probable that the entity will collect the consideration requires significant management judgement. The entity while making the assessment of the customer's ability and intent to pay the consideration should also consider the recourse available to it from the GoP guarantee in the event of non-payment of consideration by the Customer. When the entity assesses it is probable that the entity will reasonably collect the consideration through enforcing the GoP guarantee, then the collectability criterion in paragraph 9(e) of the IFRS 15 appears to be satisfied and the revenue should be recognised under IFRS 15.

To the Board's understanding, the guarantee of the GoP and the Company's practice of lodging claim to the GoP for payment for any shortfall in throughput capacity indicates that the collectability of amount due is probable, perhaps with delay and/or through GoP involvement. In terms of IFRS 15, the Board understands revenue should be recognised.

Consideration of impairment requirements of IFRS 9

The Board noted that in context of the submitted fact pattern, it is also important to highlight that the management would also be required to consider the impairment of above trade receivable from the Customer. Under IFRS 9, financial assets are classified according to the business model for managing them and their cash flow characteristics.

Under the ECL model, the assumption is that all financial assets are exposed to credit losses that may occur over the course of their lives. Now it is no longer necessary for a credit event to have occurred before credit losses are recognised. Instead, an entity always accounts for expected credit losses, and changes in those expected credit losses. The amount of expected credit losses is updated at each reporting date to reflect changes in credit risk since initial recognition and, consequently, more timely information is provided about expected credit losses.

The ECL model is applied to those assets and any others that are subject to IFRS 9 impairment accounting, a group that includes lease receivables, loan commitments and financial guarantee contracts.

Relevant paragraph 5.5.1 of IFRS 9 is reproduced below:

“An entity shall recognise a loss allowance for expected credit losses on a financial asset that is measured in accordance with paragraphs 4.1.2 or 4.1.2A, a lease receivable, a contract asset, or a loan commitment and a financial guarantee contract which the impairment requirements apply in accordance with paragraphs 2.1(g), 4.2.1(c) or 4.2.1(d).”

The Board understands that under the ECL model, the assumption is that all financial assets are exposed to credit losses that may occur over the course of their lives. Therefore, the overarching principle of IFRS 9 is that an entity will recognize an allowance for credit losses that results in the financial statements reflecting the net amount expected to be collected from the financial asset.

Therefore, in accordance with IFRS 9 the measurement of ECL should reflect:

- A range of unbiased and probability-weighted outcomes.
- The time value of money.
- Reasonable and supportable information based on the consideration of historical events, current conditions and forecasts of future economic conditions.

Further, the Board understands that as per IFRS 9, a sovereign guaranteed or highly collateralized financial instrument may also have a probability of default (i.e. credit risk) due to expected timing of the recovery of cash flows. Paragraph B5.5.28 of IFRS 9 explains that the determination of ECLs considers both the amount and timing of the payments. Therefore, a credit loss arises even if the entity expects to be paid in full but later than when contractually due. Accordingly, in the submitted fact pattern, the management would need to consider the above requirements of IFRS 9 and determine ECL provision (if any) required to be recognised against trade receivables.

Re-evaluation of scoping requirements of IFRS 16 & IFRIC 12 in the submitted fact pattern

The Board noted that the matter of assessing the submitted fact pattern under IFRIC 12 *Service Concession Arrangement* and IFRS 16 *Leases* has not been raised by the enquirer. However, based on the information provided in the enquiry, the Board finds it important to mention that management should also re-evaluate the scope of the IA with the Customer under IFRIC 12 and IFRS 16.

The enquirer has submitted in the enquiry that:

- IFRIC 12 is not applicable as the terminal is being maintained on Build, Operate and Own (BOO) basis. However, the Board would like to mention that in case the IA with the Customer covers substantially all of the economic life of the terminal, then such an arrangement could fall under scope of IFRIC 12, subject to fulfillment of other scoping criteria.
- IFRS 16 is not applicable as the entity is not providing services exclusively to the Customer and other OMCs may also directly approach the Company for throughput services. However, the Board understands that arrangement may still fall under the scope of IFRS 16 if the Customer is acquiring ‘substantially’ all economic benefits from the terminal and has the power to direct the use of the terminal.

Paragraph 5 of IFRIC 12 requires that this interpretation applies to public-to-private service concession arrangements if (underline is ours):

(a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and

(b) the grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the infrastructure at the end of the term of the arrangement.

Paragraph 6 of IFRIC 12 then explains that if the infrastructure used in the arrangement is for its entire useful life (whole of life assets) then it is within scope of IFRIC 12 if conditions in paragraph 5(a) above are met. Accordingly, to the Board's understanding, if the implementation agreement in the enquired scenario is for entire useful life of the terminal, then it will fall under scope of IFRIC 12.

Similarly, the Board noted that paragraph 9 of IFRS 16 defines a lease as “(a) contract that conveys the right to control the use of an identified asset for a period of time in exchange for consideration”. The key aspects of definition are that in the lease contract:

- (a) the asset subject to lease must be specifically identified; and
- (b) the right to control use of that identified asset must for a period of time.

The Board further noted that, in accordance with IFRS 16, once an asset is identified, then a lease exists when the customer controls the use of that identified asset throughout the period of use. IFRS 16 explains the ‘control principle’ as:

- the right to obtain substantially all of the economic benefits from use of the identified asset; and
- the right to direct the use of the identified asset.

Paragraph B21 of the Application Guidance of IFRS 16 provides further guidance for determining whether the customer has the right to obtain substantially all of the economic benefits from use of the identified asset. It explains that a customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

Paragraph B24 of the Application Guidance of IFRS 16 states that a customer has the right to direct the use of an identified asset throughout the period of use only if either:

- (a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use; or
- (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
 - (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
 - (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

(March 05, 2020)

1.10 Audit Report based on ATR-17**Enquiry**

A member enquired that Audit Report based on ATR-17 is quite lengthy and would sign on second page, so whether the first page should be initialed, signed, stamped or left blank being on letter form.

Opinion

The Committee notes that the auditor's report shall be signed in accordance with the International Standards on Auditing as applicable in Pakistan. Other pages of the auditor's report may be initialed, signed, stamped or left blank in accordance with the internal policy of the auditor.

(July 25, 2019)

1.11 Opinion on accepting audit engagement

Enquiry

We are the auditor of a Punjab Government Organization that is a body corporate and formed as an “Authority”. We have audited the financial statements of the Authority up till, say, year ending 2004. The entire financial records of the Authority were burnt to ashes, say, in 2013 and therefore the Authority was unable to get its financial statements audited as these could not be substantiated with supporting evidences and other records. The Authority is requesting that as the records from the Year 2004 to 2013 are not available, we may undertake the external audit from the year 2013 onwards leaving the span from 2005 to 2013. In this situation, we would like to enquire whether can we undertake the audit of financial statements from the year 2013 without doing the audit of the years from 2005 to 2012?

Opinion

The Committee based on the information provided in the enquiry notes that:

1. The auditor’s roles and responsibilities in an audit of financial statements are outlined under the International Standards on Auditing as applicable in Pakistan (ISAs) and legal/statutory framework under which auditor is appointed.

The reporting entity’s responsibilities related to the financial statements and other matters are also set out in the ISAs and legal/statutory framework and directives under which such an entity is established.

2. Whenever reporting entity limits or denies auditor’s access to information, the auditor should consider whether that circumstance has implications regarding management integrity and whether it might indicate the possible existence of fraud. Generally, since the restriction on the scope of the audit emanates from the highest levels of management, the auditors should consider withdrawing from the engagement and should also consult with their legal counsel.

International Standard on Quality Control 1 (ISQC 1) ‘Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements’ also requires that the firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm:

- is competent to perform the engagement and has the capabilities, including time and resources, to do so;
- can comply with relevant ethical requirements; and
- has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity.

(Emphasis is ours)

With regard to ‘integrity of client’ ISQC1 enlists various matters that require firm’s consideration. One of the factors noted is indication of an inappropriate limitation in the scope of work.

Further, in accordance with ISA 220 ‘*Quality Control for an Audit of Financial Statements*’ at the time of acceptance / continuance of client / engagement the auditor also needs to

conclude that there is no reason to believe that the overall risk associated suggests that the client should not be accepted.

Relevant paragraph 12 is reproduced here under:

“The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate.”

3. In accordance with ISA 210 ‘Agreeing the Terms of Audit Engagements’ auditor at the time of acceptance of the engagement is required to ensure that:
 - preconditions for an audit are present i.e. there is an acceptable financial reporting framework for preparation of the financial statements and the management agrees on the premise on which the audit is conducted; and
 - there is a common understanding with management on the terms of the audit engagement.

The auditor must obtain the agreement of management that it acknowledges and understands its responsibility:

- a) For the preparation of the financial statements in accordance with the applicable / acceptable financial reporting framework.
- b) For internal controls to enable the preparation of financial statements which are free from material misstatement, whether due to fraud or error.
- c) To provide the auditor with access to all information necessary for the purpose of the audit.

Management is required to prepare financial statements of the reporting entity in accordance with an applicable / acceptable accounting framework. The accounting frameworks (such as IFRS, IFRS for SMEs) require that an entity shall present comparative information in respect of the preceding period for all the amounts reported in current period’s financial statements.

In the enquired scenario, as it appears, management of reporting entity is responsible to maintain/reconstruct books of account, prepare financial statements and provide all information and documents in support of the financial statements to the auditor.

4. The auditor’s inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:
 - a) Circumstances beyond the control of the reporting entity;
 - b) Circumstances relating to the nature or timing of the auditor’s work; or
 - c) Limitation imposed by management.
5. If management imposes a limitation on the scope of the auditor’s work in the terms of a proposed audit engagement, the auditor should decline the audit engagement if the limitation could result in the auditor having to disclaim the opinion on the financial statements, unless such an audit engagement is required under law. The engagement should also be declined if the financial reporting framework is unacceptable, or if management fail to provide the agreement outlined above.

Relevant, paragraph 7 and 8 of ISA 210 is reproduced hereunder:

“If management or those charged with governance impose a limitation on the scope

of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so."

"If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement. "

(Emphasis is ours)

6. In terms of the ISAs, the fundamental requirement is that sufficient, complete and relevant evidence is obtained to provide a reasonable basis for the auditor's conclusions and opinion. This requirement would be applicable irrespective when the circumstances are considered and concluded to be beyond the control of the reporting entity (such as entity's accounting record has been destroyed).

It is also relevant to mention that an auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

ISA 240 'The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements' outlines that:

"In planning and performing an audit to reduce the risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud."

7. In accordance with the ISAs, the auditor must be able to perform procedures sufficient to provide a reasonable basis for an opinion on the financial statements being audited. This responsibility includes obtaining sufficient appropriate audit evidence about whether comparative information included has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework.

The auditor can accept an engagement where comparative information (i.e. corresponding figures) is un-audited. However, ISAs would require consideration and application of procedures on the opening balances.

The auditor is required to consider the impact of the lost or destroyed financial records on the ability to issue an audit opinion and on additional information that needs to be disclosed in the auditor's report. The ISAs state that if the auditor is unable to obtain sufficient appropriate audit evidence regarding opening balances, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements in accordance with ISA 705 'Modifications to the opinion in the Independent Auditor's Report'.

8. Further, in the enquired scenario the auditor's ability to audit a particular period without auditing the earlier periods would be a question of law i.e. the legal/authority framework under which the entity is operating and/or auditor is appointed for the audit of financial statements. In this regard reporting entity would be required to consult and seek written guidance from the external government organization/s responsible for the oversight of the reporting entity to determine the legal or regulatory requirement for the audit of the periods for which record has been lost, and if so, how to meet those requirements. Furthermore, auditor should also see the relevant specific legislation pertaining to the entity.

The reporting entity would be required to prepare the financial statements in accordance with the applicable /acceptable financial reporting framework, supported by underlying

records and information. In accordance with the financial reporting framework, the entity's financial statements would contain corresponding figures.

The auditor needs to follow all applicable ISAs in order to render an opinion on the audited financial statements. Under the ISAs, the auditor should consider the preconditions necessary for the acceptance of audit engagement, must be able to perform procedures sufficient to provide a reasonable basis for an opinion on the financial statements being audited, and issue an audit opinion on the audited financial statements in accordance with the relevant ISAs.

(July 31, 2019)