An Insight into Accounting Periods

Selection of accounting period for a newly established entity in Pakistan could be confusing sometimes. I have tried to ease this by answering different questions that normally come across in an accountant's mind. Different aspects of accounting period can be analyzed by answering the following four (4) questions:

1. What is meant by accounting period and why is it necessary?
2. How accounting period is determined?
3. Can accounting period be changed later on?
4. Can accounting period be more or less than 12 months?

1. WHAT IS MEANT BY ACCOUNTING PERIOD AND WHY IS IT NECESSARY?

Have you ever thought about purpose of the calendar year? We have divided our whole life into small segments of time that we call 'years', and for identification of the same we use calendars. Our today's Gregorian calendar starts on 1 January and ends on 31 December (12 months in total). The objective of this division is to plan, administer and analyze different aspects of our lives e.g. social, religious, and commercial, etc.

Even our governments plan their activities using this concept. Governments plan their fiscal activities in the form of budget on yearly basis which is called a 'Fiscal Year' or a 'Financial Year'. Financial year also comprises of twelve months e.g. in Pakistan it starts from 1 July and ends on 30 June in next year; in USA it starts from 1 October and ends on 30 September; in India it starts from 1 April and ends on 30 March; and in China it starts from 1 January and ends on 31 December.

Organizations also use financial years for planning, control and performance evaluation purposes. From accounting point of view, the term used, however, is called 'Accounting Period'. This is the period for which financial statements of an entity are prepared. This period normally comprises of twelve months. However, in some circumstances as discussed later in the article, it may comprise of more than or even less than twelve months. Accounting periods also normally end on 31 March, 30 June, 30 September or 31 December. However, this is not the rule of thumb; accounting period may, for example, start from 16 December and end on 15 December in next year.

2. HOW ACCOUNTING PERIOD IS DETERMINED?

After understanding the need for accounting period, the next question that needs to be answered is how you determine the accounting period for a newly 'borne' entity.

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Accounting period is determined by the management of the entity. Determination of accounting period comprises of two steps:

a. Considering the relevant law(s) under which the entity is established/incorporated; and
b. Considering the relevant provisions of income tax law(s).

Both these steps are explained below.

a. *Entity Incorporation Laws*:

Under which law your entity is incorporated? Well, it will depend upon the business you are in. Below, I have tried to jot down a brief list of businesses and relevant corporate laws in Pakistan that could impact the determination of accounting period:

- *Banks/Banking Companies* – Accounting Period Ends on 31 December

  Relevant corporate laws include Companies Ordinance, 1984, Banking Companies Ordinance, 1962 and Directives issued by Securities and Exchange Commission of Pakistan (SECP) & State Bank of Pakistan (SBP).

  Section 32(1) of the Banking Companies Ordinance, 1962 suggests that close of business of banking companies occurs on "thirty-first day of December".

- *Insurance companies* – Accounting Period Ends on 31 December

  Relevant corporate laws include Companies Ordinance, 1984, Insurance Ordinance, 2001, SEC (Insurance) Rules, 2002 and Directives issued by SECP.

  Accounting period of insurance companies is not specified in the relevant corporate laws; however, 31 December is mentioned in accounting templates/forms given by SECP under Rule 16 & 21(1) of SEC (Insurance) Rules, 2002 (Insurance Rules). Further guidance is available in *Taxation Laws* section below.

  Accounting period of insurance brokers is 31 December as per Rule 27 of the Insurance Rules.

- *Non-Banking Finance Companies (e.g. Mutual Funds, Leasing Companies, Investment Companies, etc)* – Accounting Period Ends on 30 June

  Relevant corporate laws include Companies Ordinance, 1984, NBFCs (Establishment and Regulation) Rules, 2003, NBFCs and Notified Entities Regulations, 2008, REIT Regulations 2015 and Directives issued by SECP.

Although, there is no specific provision in the above mentioned laws that precisely stipulates the accounting period for NBFCs, guidance for the same may be obtained from Notified Entities Regulations, 2008 (NE Regulations). For example, minimum equity requirements of NBFCs under Regulation 4 (Schedule I) and classification & provisioning requirements for non-performing assets under Regulation 25 (Schedules X & XI) of NE Regulations are applicable considering "30 June" as year-end. Further guidance is also available in *Taxation Laws* section below.

- *Modarabas* – Accounting Period Ends on 30 June

  Relevant corporate laws include Modaraba Companies and Modarabas (Floating and Control) Ordinance, 1980, Modaraba Companies and Modaraba Rules, 1981, Prudential Regulations for Modarabas and Directives issued by SECP.

  Accounting period for Modarabas is not specified in the relevant corporate laws. Therefore, we would consider the guidance available in *Taxation Laws* section below.

- *Trading/Manufacturing/Service Providing Companies (e.g. Sugar, Textile, Cement, Tobacco, Oil & Gas, Power, Petroleum, Engineering, Construction, Automobile, Transport, Telecom, Fertilizer, Pharmaceutical, Chemical, Leather, Food, FMCGs, Health, Hotel, Entertainment & Media, Consultancy, Education, etc)* – Accounting Period Ends on June 30

  Relevant corporate laws include Companies Ordinance, 1984 and Directives issued by SECP.

  Accounting period for such companies is not specified in the relevant corporate laws. Therefore, we would consider the guidance available in *Taxation Laws* section below.

- *Corporations/Body Corporates* – Accounting period as defined in relevant incorporation law

  These are the entities that are incorporated under a specific law e.g. WAPDA is established under WAPDA Act, 1958. The relevant law should be considered for each such entity while determining the accounting period.

  Guidance for determining accounting period of these entities may or may not be provided in the relevant incorporation laws. Therefore, we would also consider the guidance available in *Taxation Laws* section below.

- *Non-Profit Organizations* – Accounting period on the basis of taxation laws

  There are different laws under which NPOs can be formed. If NPO is a (Sec 42) company the relevant corporate laws would be Companies Ordinance, 1984 and Directives issued by SECP. If NPO is a society, trust or a social welfare agency the relevant corporate laws would be Societies Registration Act, 1860, Trust Act, 1882 and

Voluntary Social Welfare Agencies (Registration and Control) Ordinance, 1961 respectively.

Accounting period of NPOs is not specified in any relevant law i.e. Companies Ordinance, 1984, Societies Registration Act, 1860, Trust Act, 1882, etc. Therefore, we would consider the guidance available in <u>*Taxation Laws*</u> section below.

- *Un-incorporated Structures e.g. sole proprietors and partnerships* – Accounting period on the basis of taxation laws

  There is no specific incorporation law for such entities. However, partnership relationships are governed by Partnership Act, 1932.

  Guidance regarding determination of accounting period of NPOs is available in <u>*Taxation Laws*</u> section below.

b. <u>Taxation Laws</u>:

Although the first point of reference for accounting period determination, as discussed above, is the relevant corporate laws, however, you might have noticed that not all corporate laws provide guidance for determining the accounting period. Therefore, taxation laws are equally important. Important provisions of Income Tax Ordinance, 2001 (ITO) regarding accounting period (in tax laws this may be called the Tax Year) are briefly explained below.

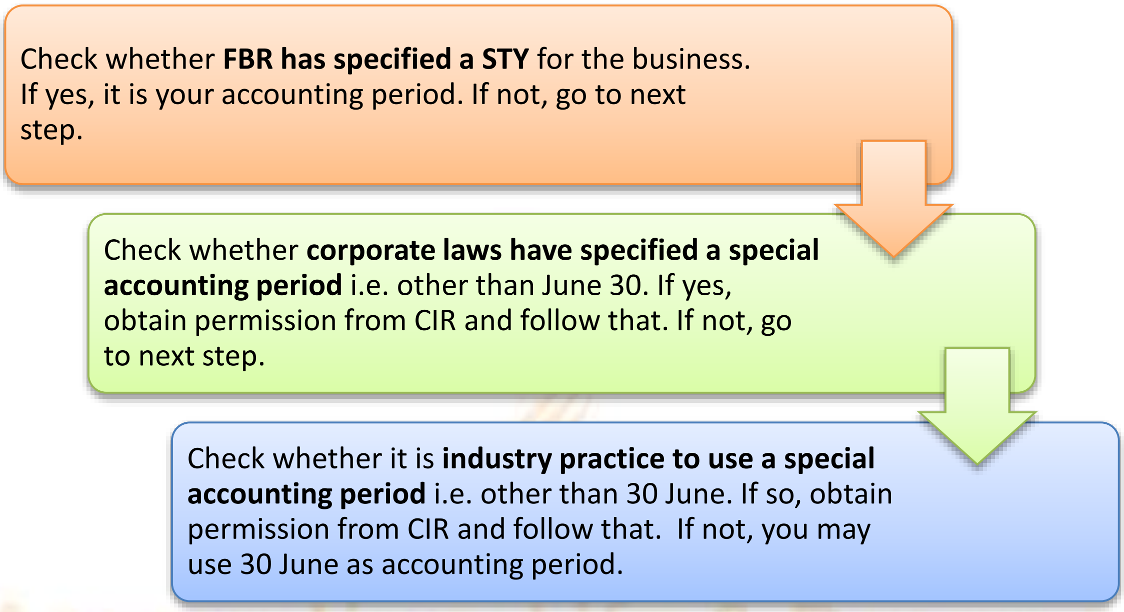
As per Section 74 of ITO, every company should have a year-end which ends on 30 June. In taxation terms it is known as Normal Tax Year (for ease of understanding, you may use the terms accounting period and tax year interchangeably). However, you will notice that some company laws have prescribed different accounting periods i.e. other than 30 June. Therefore, there is a provision of Special Tax Year (STY) in ITO. STY is any tax year other than normal tax year. STY can be adopted in two ways.

One, FBR has specified a STY for the entire class of business. Given below is a list of STYs specified by FBR (only active S.R.Os as on 28 October 2015).

1. Jute goods manufacturers: Year-end 30 June (SRO 133(R)/68 dt. 31.07.1968)
2. Sugar manufacturers: Year-end 30 September (SRO 134(R)/68 dt. 31.07.1968)
3. Rice husking business: Year-end 31 August (SRO 1153(I)/79 dt. 10.12.1979)
4. Shawl manufacturers and traders, etc: Year-end 31 March (SRO 505(I)/80 dt. 15.05.1980)
5. Insurance companies: Year-end 31 December (SRO 878(I)/95 dt. 30.08.1995)

Two, you make an application to the Commissioner Inland Revenue (CIR) for adopting a STY (such an application can only be made if there is a compelling need for that). For example, neither ITO nor Companies Ordinance, 1984 has specified any STY for fertilizer manufacturing companies; therefore, these companies should follow the normal tax year i.e. 30 June. However, as an industry practice these companies follow 31 December as year-end, which means they have to obtain special permission from the CIR, on case to case basis, for adopting 31 December as year-end.

The above discussion can be summarized in the form of a flow diagram for establishing the steps for determining the accounting period of an entity.



3. CAN ACCOUNTING PERIOD BE CHANGED LATER ON?

The answer is Yes! The accounting period determined by the management can be changed later on. For that, you need to get the following approvals:

- Get approval of change in the accounting period from those charged with governance e.g. the board of directors.
- Get approval from relevant regulatory authorities (e.g. SECP), if such an approval is required by the relevant corporate law(s). For example, in case of a company, application for change in accounting period to the Registrar of Companies, Securities and Exchange Commission of Pakistan (SECP) under Rule 30 of the Companies (General Provisions and Forms) Rules, 1985 is required; in case of a Modaraba, approval from Registrar of Modarabas, SECP under Rule 11(2) of Modaraba Companies and Modaraba Rules, 1981 is required.

- Get approval from the Commissioner Inland Revenue (Income Tax) under Section 74 of the Income Tax Ordinance, 2001.

When all above approvals have been obtained, the accounting period of company is changed.

4. CAN ACCOUNTING PERIOD BE MORE THAN OR LESS THAN TWELVE MONTHS?

Yes. However, this can happen only in few circumstances. Such circumstances, in light of the provisions of the Companies Ordinance, 1984 (the Ordinance), are briefly explained below.

1. *This is the first year of the entity* e.g. a textile company is incorporated on May 01, 2015 and its accounting year ends on June 30. Section 233(1) of the Ordinance states that the first accounts are prepared since the incorporation of the company. Section 233(2) states that the accounting period shall not exceed twelve months except where special permission has been granted by the registrar in that behalf. Therefore, it can be said that the first accounting period of the company might comprise of either 2 months i.e. May 01, 2015 to June 30, 2015 or 14 months i.e. May 01, 2015 to June 30, 2016.

   If management intends to prepare first financial statements for 2 months, no problem in that. However, if the management intends to prepare first financial statements for fourteen-month period there would be a fun part.

   As discussed above, if the period to which financial statements relate exceeds twelve months, a special permission shall have to be obtained from the registrar (on an application of the company). This means if the management intends to prepare first financial statements for 14 months, it will have to obtain prior permission from the registrar to prepare accounts from May 1, 2015 to June 30, 2016. If such permission is not obtained, the first accounts shall be prepared for two-month period i.e. up to June 30, 2015.

2. *When the management changes the accounting period* of the entity. As stated in paragraphs 4 & 5 of Chapter 1 of 'A Guide on Accounts and Accounting Reference Dates' of SECP, accounting reference date (e.g. 30 June) can be changed (by shortening or extending the accounting period) by making an application to the concerned Registrar under Rule 30 of the Companies (General Provisions and Forms) Rules, 1985.

   For example, recent accounting period of a company ended on June 30, 2014. During November 2014, the management changed its accounting period by shortening the accounting period from 30 June 2015 to 31 December 2014. Therefore, next accounting period of the entity might comprise of six months i.e. July 01, 2014 to December 31, 2014.

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3. *In the last year of the entity* (i.e. the company is dissolved). 'Guide on Winding up / Dissolution of Companies' of SECP defines winding up as 'proceedings by which the life of a company is put to an end'. This means that during last year of a company, it might not run its affairs for the whole year, and therefore, last accounting period of the company, subject to the provisions of the Ordinance, might be less than twelve months.

   Section 402 of the Ordinance states that from the date of commencement of the winding up of a company, the official liquidator or the liquidator, as the case may be, is deemed to have taken the place of the directors, chief executive, etc of the company. Therefore, responsibility for management and administration of the company including preparation of accounts and statements transfers to the liquidator.

   Section 402 also states that a company being wound up continues to be a company for all purposes (i.e. including preparation of accounts by the liquidator) till its final dissolution. Sections 370 and 382 deal with final meeting and dissolution of the company which require the liquidator to call a (final) general meeting of the company for the purpose of laying the (final) report and accounts before it. Such report and accounts are prepared up to a date on which the affairs of the company are fully wound up (Sec 370(1) & Sec 382(1)).

   For example, affairs of ABC Company are fully wound up on January 31, 2015 and previous accounts of the company were prepared by the liquidator up to June 30, 2014. The last accounting period of the company would comprise of seven months i.e. July 01, 2014 to January 31, 2015.