

REPORT
OF
THE TASK FORCE
ON
TRANSFER PRICING

December 30, 2005

1. Introduction

The Securities and Exchange Commission of Pakistan (SECP) had introduced transfer pricing requirements in the year 2003 through the Listing Regulations of the stock exchanges and the Fourth Schedule to the Companies Ordinance, 1984. The chronology of developments in regard to the enforcement of and amendments in transfer pricing requirements is as under:-

December 31, 2002: The SECP considered amendments in the 4th Schedule as it was believed that any price other than arm's length price would lead to "distortion of true and fair view of the affairs of the company in the financial statements".

January 02, 2003: 4th Schedule was amended and the amendments became effective from January 22, 2003. Definitions of arm's length price, related party and transfer pricing were inserted along with the requirement of complete disclosure. Different methods of price computation were identified but without putting a definition on what each method implied. Very briefly the requirements provided that arm's length pricing principles shall be followed in dealings with related parties and disregard of the principle could be made only with the approval of BOD and Audit Committee.

January 21, 2003: Exchanges were directed by the SECP to make amendments in the respective listing regulations in order to make transfer pricing regulations an integral part thereof. The requirements in the 4th Schedule were from the point of view of disclosure in financial statements while those in listing regulations also included the standardized procedure for consideration of the related party transactions and decision making on transfer pricing.

February 14, 2003: A form of audit report was prescribed for reporting by statutory auditors of compliance by the company management with

transfer pricing requirements. This was done through SRO No. 167(1)/2003 dated 14-02-2003. This notification still holds ground and has neither been rescinded nor held in abeyance. However, neither compliance therewith has been insisted by SECP nor have the statutory auditors complied.

February 25, 2003: Regulations were gazette notified by stock exchange(s).

August 07, 2003: The earlier directive dated January 21, 2003 was substituted by a fresh directive to stock exchanges. Some softening of transfer pricing requirements was achieved through this.

January 28, 2004: The SECP instructed the stock exchanges that provision regarding review and certification of “Statement of compliance with the best practices” by the auditors shall be applicable from the financial year beginning on or after October 1, 2003.

January-May, 2004: Several companies as well as OICCI and ICAP agitated different problems in compliance with the requirements. A committee within SECP was formed to review the requirements.

June 03, 2004: The committee submitted its Report and gave the following recommendations:-

- The Commission may defer the application of requirements on related party transactions and transfer pricing, as contained in the Fourth Schedule and the listing regulations, for a period of six months. During this period, necessary consultation with stakeholders should be undertaken to bring them on board about the SEC’s approach to address the issue of transfer pricing and refine the existing legal requirements on transfer pricing, if necessary.
- The requirements on transfer pricing, as determined in consultation with stakeholders, should be either notified as rules in exercise of

power under Section 506 of the Companies Ordinance, 1984 or notified in terms of Section 246 of the Companies Ordinance, 1984.

July 05, 2004: The 4th Schedule was substituted vide notification S.R.O. 589 (I)/2004 dated 5th July, 2004. The paragraph requiring disclosure of accounting policy in respect of related party transactions and transfer pricing as well as identifying different methods of price computation was deleted.

November 12, 2004: To facilitate consideration of the issues still more objectively, SECP issued a notification/directive granting exemption to listed companies and their subsidiaries from application of transfer pricing provisions in the Companies Ordinance, 1984 and the Listing Regulations. This exemption was continued and is presently available up to 31st December, 2005.

2. Constitution of Task Force

Keeping in view the significance of the issue, SECP felt it desirable that a holistic view of the situation is taken so that accounting and disclosure as well as taxation issues emanating from these requirements are dealt with properly. It was, therefore, decided that a joint task force on transfer pricing be established by SECP and CBR associating not only representatives from both the organizations but the private sector and the professionals.

It was in pursuance of this decision that the SECP and CBR constituted a Joint Task Force on transfer pricing on September 20, 2005 to study issues concerning the accounting, measurement, reporting and allied matters on related party transactions and provide appropriate recommendations. The Task Force comprised the following members:-

1. Mr. Riaz A. Malik (Ex-Chairman Central Board of Revenue)	Chairman
2. Mr. Salman Nabi (Member Tax Central Board of Revenue)	Member
3. Mr. Moin M. Fudda (Honorary Consul General of New Zealand for Pakistan and now Country Director, CIPE)	Member
4. Mr. Kamran Mirza, Chief Executive(Abbott Laboratories (Pakistan Limited)	Member
5. Mr. Khalid Yaqoob (Packages Limited)	Member
6. Mr. Mujahid Eshai, (F.C.A) FCA, A.F. Ferguson & Co.	Member
7. Syed Mohammad Shabbar Zaidi (FCA, A.F. Ferguson & Co.)	Member
8. Dr. Ikramul Haq (Advocate Lahore Law Associates)	Member
9. Ms. Jaweria Ather (Director SECP)	Member
10. Syed Fayyaz Mahmud (Director SECP)	Secretary

The Task Force was required to complete its task by December 31, 2005.

3. Terms of Reference

The Terms of Reference of the Task Force are:-

- (a) Which stakeholders are affected by transfer pricing?
- (b) What are the differences between transfer pricing provisions contained in the corporate law (including listing regulations) and those in the tax law? How does one support the other?
- (c) Which requirements of listing regulations and Fourth Schedule to the Companies Ordinance, 1984, pertaining to related party transactions and transfer pricing, extend beyond IAS 24?
- (d) Whether the information that is required beyond IAS 24 can be provided by corporate managements and is there a verifiable basis for providing such information?
- (e) Whether the auditors have the capacity to review and provide an opinion on the disclosures and procedures required by IAS 24, listing regulations and Fourth Schedule?
- (f) Whether additional disclosures beyond IAS 24 and auditor's certificate are required in other jurisdictions?
- (g) If so, are such disclosures covered in the corporate legislation or the tax legislation or both in other jurisdictions.
- (h) Any other matter relating to transfer pricing which the Task Force may like to comment on.

4. Methodology used by the Task Force

- 4.1** The Task Force solicited views of the public at large through a press release dated September 20, 2005. Only ICAP submitted its comments in response to the press release.
- 4.2** Apart from the formal meetings of the Task Force at Islamabad, the Chairman of the Task Force traveled to Karachi and Lahore to individually meet with and solicit views of the members of the Task Force. This was essential in view of the importance of the issues involved and their wide ranging implications as well as the short time available for submission of the report. Besides, this opportunity was used to involve some other stakeholders including the OICCI.

5. Discussions by the Task Force

The members of the Task Force expressed their views candidly in the various meetings. This input oscillated between two extremes. One view was that existing regulation as provided in both the Listing Regulations and the 4th Schedule was outside the purview of internationally accepted corporate law requirements and should be withdrawn in entirety. The other view was that the stringent regulations in the Australian legislation and the under-consideration Indian Irani Committee Report provide models which should be emulated in Pakistan. Having regard to the need for development of sound corporate culture in Pakistan that is conducive to growth of the corporate sector rather than having any stifling effect, the Task Force unanimously felt that:-

- There is need for objective oriented requirements under the corporate law that encourage transparency and disclosure.

- In a developing economy like ours, there is a need to place greater emphasis on encouraging investment and growth.
- IAS-24 has been prescribed by and is followed by countries around the world. It will be useful to concentrate on having a full and proper application of IAS-24 by companies.
- We should allow the capital market to continue to grow and refrain from any measures which result as a disincentive for listing. As such, the issue of transfer pricing is not limited to listed companies only.
- The question of having uniform requirements in the tax and the corporate laws was also deliberated upon by the Task Force. It was felt that the tax law provided for wide power to tax department to obtain any related information from the assessee and that such powers are neither asked for by SECP nor are desirable. Accordingly, there is no need to have or attempt to have any uniformity of requirements of disclosure under the two laws. Restrictions on powers of tax authorities were also not favoured either. It was felt that the thinking reflected above is in conformity with the practice in an overwhelming number of countries.
- *Viz-a-viz* the TORs, the Task Force recognized that:-
 - ✓ the shareholders are the most critically important stakeholders under the corporate law regime. It is their interest which the corporate regulator must aim at protecting. The appropriate instruments for that are transparency, disclosure and improved governance.
 - ✓ the corporate and tax regimes are different and need to be allowed to remain so.

- ✓ the requirements of the Fourth Schedule are additional to the requirements of IAS-24. The listing regulations set out procedures to be followed within companies in respect of related party transactions, which is not the subject matter of IAS-24.
- ✓ some of the information required in terms of the existing requirements of the Fourth Schedule and the listing regulations does not have a verifiable basis.
- ✓ auditors do not have the capacity to verify such information.
- ✓ with respect to corporate legislation, Australian Corporation Act 2001 mandates disclosures to and approvals from shareholders on related party transactions that are not on arm's length basis.
- Notwithstanding the above views, the Task Force strongly felt that the objective of protection of the interests of shareholders, greater transparency and improved corporate governance must be strongly pursued. With this in view, the Task Force discussed a wide range of options. The existing requirements in the Listing Regulations and the 4th Schedule to the Companies Ordinance, 1984 were carefully reviewed. Fundamental changes were unanimously agreed as per details below.

6. Recommendations:

6.1. Listing Regulations.

The Task Force unanimously recommends that the existing listing regulation no. 38 of the Karachi Stock Exchange Listing Regulations (and similar provisions contained in the Listing Regulations of the

Lahore and Islamabad Stock Exchanges) and its heading be replaced with the following:-

“Related Party Transactions.

(1) All companies registered under the Companies Ordinance, 1984 shall place before the Board of Directors all the transactions with the related parties for review and approval

(2) The detail of all related party transactions shall be placed before the Audit Committee of the company.

(3) The related party transactions which are not executed at arm’s length price will also be placed separately at each Board meeting along with necessary justification for consideration and approval of the Board and before the Audit Committee of the company.

(4) The Board of Directors of a company shall approve the pricing methods for related party transactions that were made on the terms equivalent to those that prevail in arm’s length transaction only if such terms can be substantiated.

(5) Every company shall maintain a party wise record of transactions, in each financial year, entered into with related parties in that year along with all such documents and explanations. The record of related party transaction shall include the following particulars in respect of each transaction:-

- i) Name of related party;
- ii) Nature of relationship with related party;
- iii) Nature of transaction;
- iv) Amount of transaction;
- v) Terms and conditions of transaction, including the amount of consideration received or given.”

6.2 The proposed listing regulation may be made a part of the Code of Corporate Governance with necessary disclosures made in the statement of compliance with the Code of Corporate Governance, as published in annual reports of listed companies.

6.3 4th Schedule. The IAS-24 has been made applicable by SECP to all listed companies which are accordingly required to comply with the requirements of that Standard. No purpose would be served by repeating some of the requirements of IAS-24 in 4th Schedule. Given the focus to achieve better compliance with IAS-24, the additional requirements in the 4th Schedule may be done away with along with the additional audit opinion prescribed through notification No. S.R.O.(1)/167/2003 dated 14th February, 2003.

6.4. Private and non-listed public companies.

The issue of transfer pricing extends across the corporate sector and is not limited to any class of companies. It is, therefore, recommended that the application of the IAS-24 and the requirements in para 6.2.1. should extend to all companies including the non-listed public companies and the private companies other than small companies.

6.5. Exemption. It is recommended that SECP should not grant any exemption from the requirements to any company or class or group of companies except small companies as defined in the Income Tax Ordinance 2001 through an amendment made by the Finance Act 2005.

6.6. Ensure compliance with requirements of IAS-24. SECP should issue a circular or directive to all companies to ensure compliance with the requirements of IAS-24, in particular paras 21 and 22 thereof.

7. The recommendations aforesaid are the unanimous recommendations of the Task Force.
