



Before Mr. Abid Hussain, Executive Director

In the matter of

A.F. Ferguson & Co. Chartered Accountants - Auditors of Tri-Pack Films Limited

Number and date of show cause notice CSD/ARN/179/2015 dated May 30, 2016
Date of Hearing July 20, 2016
Present Mr. Khurshid Hasan, Partner, Mr. Rashid Ibrahim, Partner
Mr. Muhammad Shahzad, Senior Manager, on behalf of
A.F.Ferguson & Co., Chartered Accountants

ORDER

Under Section 260 read with Section 255 & 476 of the Companies Ordinance, 1984

This order shall dispose of the proceedings initiated against Mr. Khurshid Hasan, FCA, audit engagement partner (the "engagement partner") of A.F. Ferguson & Co., Chartered Accountants (the auditor), in respect of the audit of Tri-Pack Films Limited ("the Company") for year ended December 31, 2014. The proceedings were initiated through show cause notice dated May 30, 2016 (the "SCN") under provisions of Section 260 read with Section 255 and 476 of the Companies Ordinance, 1984 ("the Ordinance").

2. The brief facts of the case emanate from examination of annual financial statements (the "Accounts") of the Company for year 2014 which revealed that owing to reconciling various balances and corresponding effects, the Company restated its accounts. As a result, comparative amounts of Profit after Taxation (PAT) and Earning Per Share (EPS) for the year ended December 31, 2013 decreased by approximately 88% from the figures previously reported in the Accounts for the year 2013. The aforementioned effect on PAT and EPS is illustrated in the table below:

Effects on Profit & Loss Account for the year ended December 31, 2013

	<i>As previously reported</i>	<i>As restated</i>	<i>Decrease due to Restatement</i>
<i>PAT</i>	<i>Rs.209.156 M</i>	<i>Rs.25.394 M</i>	<i>Rs.183.762 M</i>
<i>EPS</i>	<i>Rs.6.97</i>	<i>Rs.0.85</i>	<i>Rs.6.12</i>



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3. Perusal of note 4 to the Accounts further revealed that during the year, the Company while reconciling various reported amounts, identified that balances relating to sales tax recoverable and LC margin held by banks were understated and advances were overstated in the Accounts for the year ended December 31, 2012, liability for imported goods were understated in both the Accounts for the year ended December 31, 2012 and 2013 with a corresponding overstatement in the profit for the year ended December 31, 2013 and unappropriated profit as at January 01, 2013. The effects of the restatements on the balance sheet and profit and loss account is illustrated in the table below:

<i>Effects on balance sheet as at December 31, 2013</i>		<i>(Rs. in thousand)</i>	
	<i>As previously reported</i>	<i>As restated</i>	<i>Restatement</i>
<i>Stock in trade</i>	2,485,187	2,307,567	(177,620)
<i>Advances and prepayments</i>	149,763	275,592	125,829
<i>Other receivable</i>	139,650	123,150	(16,500)
<i>Deferred taxation</i>	299,888	201,494	(98,394)
<i>Trade and other payable</i>	2,742,581	3,034,652	292,071
<i>Reserves</i>	1,777,185	1,513,217	(261,968)

<i>Effects on Profit and loss account for the year ended December 31, 2013</i>		<i>(Rs. in thousand)</i>	
	<i>As previously reported</i>	<i>As restated</i>	<i>Restatement</i>
<i>Cost of sales</i>	10,516,592	10,774,985	258,393
<i>Distribution cost</i>	294,343	334,843	40,500
<i>Other expenses</i>	23,573	6,836	(16,737)
<i>Taxation</i>	108,901	10,507	(98,394)
<i>Decrease in profit after tax</i>			183,762

4. The aforesaid understatements and overstatements of respective balances and consequent restatement had a material impact on the Accounts of the Company for the relevant periods. As a result, the Accounts of the Company for the years ended December 31, 2013 and 2012 were, prima facie, materially misstated. The respondent, being audit engagement partner of the Auditor of the Company, issued audit report dated March 30, 2014 and March 30, 2013 (the "Reports") to the members. However,



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the Reports did not include any qualification with regard to the material effect on the Accounts of the Company for the year ended December 31, 2013 and 2012.

5. In view of the above, *prima facie*, the auditor failed to obtain reasonable assurance that the underlying accounts were free from material misstatement either due to fraud or error, failed to demonstrate professional skepticism while planning and performing audit and thereby failing to bring out material facts about the affairs of the company. The respondent in the Reports, on the Accounts of the Company for years 2013 and 2012, failed to qualify their report in accordance with the International Standards on Auditing ("ISA") and in conformity with Section 255 read with Section 260 of the Ordinance.

6. Keeping in view the facts enumerated above, the SCN was issued to the engagement partner, advising him to show cause as to why penal action may not be taken against him for failing to perform the audit of the Accounts as per requirement of the Ordinance and relevant ISAs and to make a report to the shareholders in accordance thereof.

7. The response of the engagement partner vide letter dated June 20, 2016 with respect to the SCN is summarized below:

i. The contents of show cause notice are based solely on the basis of examination of the account-2014 in which restatement was made. Reference was made of ISA 200, Paragraph A52 that stated:

"Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with ISAs. Accordingly, subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not be itself indicate a failure to conduct an audit in accordance with ISAs..."

ii. As per provisions of ISAs the happening of restatement in itself does not establish that the auditor of financial statements of which the restatement relates was not properly conducted. We believe that in order to conclude on the statements made in paragraph 11 to 13 of the show



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cause notice it is imperative to determine whether the audit was properly conducted in accordance with the ISAs applicable in Pakistan.

- iii. The issue represents a matter in nature of fraud or error in the preparation of the financial statements for the years ended June 30, 2012 and 2013 by the management and as auditors of those years we had no knowledge of that matter.
- iv. ISA 240 'the auditor's responsibilities relating to fraud in an audit of financial statements' provides specific guidelines on the limitations on auditor's responsibilities in such cases. Further, as per ISA 200, the potential effects of inherent limitations are particularly significant in case of mismanagement resulting from fraud. Further more risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud as management is in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.
- v. Audit procedures performed during the audit of financial statements of the Company for the year 2012 and year 2013 were provided. This included calculating materiality level, understanding company's environment, reviewing minutes of Board of Directors and its committees, assessing and planning fraud risk, performing risk assessment procedures, understanding management's assessment of risk of material misstatement, understanding control environment, communicating audit committee finding and tailoring audit programme accordingly.
- vi. We carried out our audit in accordance with the requirements of ISAs and to the best of our information and according to the explanations given to us. The detailed audit procedures relevant for the understanding of work done in relation to the account heads that were restated and fraud risk assessment are given (summarized):
 - According to ISAs, an audit is conducted by selecting a sample of transactions and balances. The nature and size of sample is determined w.r.t level of risk of material misstatement assessed by audit and nature of account balance



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- Procedures performed during the audit for year 2012 and 2013 are following:

a) Cost of Sales- Raw Material consumption

Performed substantive analytics in accordance with requirements of ISA 520. Expectation of the expected raw material consumption was built by adjusting the raw material consumption per tonne for the prior year with average increase in prices of raw material during the year and applying adjusted amount to the current year production. Verified sample of raw material purchased during the year with the underlying supporting documents such as invoices, purchase orders, good received notes etc. in accordance with ISA 500.

b) Liability of imported goods

Liability of imported goods comprises of general ledger accounts. We were provided a list of liabilities pertaining to imports. We selected sample of import related liabilities from the schedule provided by the management and verified balances with supporting documents. We have also checked payments made to foreign vendors subsequent to the year end. In respect of other balances which mainly related to import related accruals we conducted verification by applying a percentage on the outstanding amount of liability. Performed a test of unrecorded liabilities by checking payments exceeding threshold made subsequent to year end to check whether liability relating to these payments were booked at year end.

c) Journal Entry testing

Extracted a complete list of journal entries passed during the year. Based on risk assessment a sample of journal entries passed during the year meeting the criteria were checked. Written representation was also obtained through management letter for year 2013 (similar for representation letter for year 2012) in accordance with ISA 580 which included the following clauses:

- i. assurance of management about the accuracy and completeness of liabilities.
- ii. Management acknowledging responsibility for design, implementation and maintenance of internal control to prevent and detect fraud and error



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- iii. Assurance of management of having no knowledge of fraud or error affecting company involving management, employee and others that have material effect on financial statements
- iv. Disclosed the results of our assessment that results of our risk assessment regarding financial statements maybe materially misstated as a result of fraud
- v. Management has no knowledge of any violation of possible violation of laws or regulations whose effect should be considered for disclosure in financial statements or as a basis for recording loss contingency.

vii. The restatement was made in the accounts 2014 was result of certain unsubstantiated entries recorded in the company's general ledger which were otherwise not required to be made. Therefore, Commission is requested to review the ISA 240 (Para 6 and 7 quoted) which are distinctive guidelines on limitation on auditor's responsibilities in such cases.

viii. Penal provision of Section 260 of the Ordinance are applicable only in case of willful act which is categorically denied and is not apparent in any manner.

8. An opportunity of hearing in the matter was provided to the respondent on July 20, 2016. Accordingly, Mr. Khurshid Hasan (engagement partner), Mr. Rashid Ibrahim and Mr. Muhammad Shahzad (all three collectively called respondents) appeared on the said hearing date. The respondents reiterated the stance taken earlier in its written reply to the SCN. Further, on query regarding materiality, suspicion of fraud, risk assessment procedures and third party confirmation, the submissions of respondent are summarized below:

- a) It is admitted that the amounts were material for the years 2013 and 2012 thereby having significant impact on the financial statements.
- b) Evaluation of fraud risk factors was performed by the engagement team in view of the PwC Guide. Various fraud risk factors were evaluated however there was no information from risk assessment procedures & additional activities indicated presence of one or more fraud risk



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- factors. As there was no suspicion of fraud hence additional audit procedures were not applied and the audit report was not modified.
- c) ISAs provide guidelines on limitation on the auditor's responsibilities relating to fraud in an audit of financial statements as well as the potential effects of inherent limitations are particularly significant in case of mismanagement resulting from fraud. There is greater risk of not detecting employee fraud as they are in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.
- d) The responsibility of preparation of accounts rests with management, the responsibility of auditor is limited to the requirements of ISAs. Accordingly, the auditor performed their responsibility accordingly. Because of inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with ISAs. Accordingly, subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with ISAs.
- e) The respondent performed appropriate risk assessment procedures as provided in ISA 315. This included understanding the nature of Company, its operations, accounting policies, measurement and review of financial performance. It was however admitted that risk assessment relied heavily on past history of the company (fifth year of audit of Company by auditors) which included reliance on past audit that too performed by the respondents for year 2012-2014. It was emphasized that no other engagement was performed by Mr. Khushid Hasan for the Company.
- f) Reference was also made to most important audit software, A&C, used by respondents being part of PwC network by engagement teams to promote consistency in engagement acceptance and continuance procedures. Within A&C, the engagement team is required to answer a series of questions about the entity. The answers to these questions and interrelationship between responses will ultimately produce an A&C score and risk conditions.
- g) In case of audit of Company's financial statements, the A&C questionnaire was completed, resulting in a score that did not represent higher risk engagement risk and also no specific risk condition was identified.



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- h) As part of audit, the engagement partner and other engagement team members had discussed the susceptibility of the Company's financial statements to material misstatements and application of applicable financial reporting framework
- i) The minutes of meeting of board of directors and audit committee were reviewed. The engagement partner admitted to having knowledge of fact that the Company was shifting from manual to SAP accounting system in 2009 and this major shift that was in itself a significant indication that mandated additional risk / audit procedures. The respondents agreed that the said shift may be a reason for error.
- j) The audit procedures were reiterated as already given in reply to the SCN. It was emphasized the analytical procedures were adopted for verifying inventory, third party verification was done for local creditor despite the fact that sending confirmation for debtors is mandatory not creditors, 100% testing of journal ledger is not required also the fact that 10000-12000 journal entries hence sample was taken and the same was not indicative of fraud. Engagement partner stated that journal entries may have been posted to enhance profit that maybe termed as fraud.
- k) The audit engagement team relied on internal controls of the Company.
- l) The respondent denied any negligence in audit of the Company. Section 260 of the Ordinance requires establishment of willfulness of auditor to perform audit and make an audit report thereon in contravention to the requirements of the Ordinance. As the same is not the case, the proceedings under the subject show cause notice maybe dropped.
9. Keeping in view submissions at the time of hearing, the respondents were given time to provide additional information. The auditor responded vide letter dated August 23, 2016. The issues highlighted by this office and responses of auditors are summarized below (important portion of response highlighted to emphasize):

- a) *Issue:* Risk assessment procedures for obtaining reasonable assurance:

Response: ISAs 315 and ISA 240 have been referred as the relevant ISA. The auditor in accordance with the requirement of Paragraph 5 & 6 of ISA 315 performed risk assessment procedures. The auditors use a software tool A&C (purpose of A&C already detailed above). It is responsibility of engagement team to address and manage this identified inherent risk



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through planning and the execution of suitable audit procedures. The risk identified by A&C require review and interpretation by the engagement team & leader in order to identify underlying significant risks and the same is a key task of engagement leader in their approval of A&C assessment. The A&C questionnaire completed in audit of Company's financial statements, resulted in a score which as per our guidelines does not represent higher engagement risk and also no specific risk condition was identified triggering any significant risk.

- b) *Issue:* If the subject restatement of various balance sheet by the Company for year 2014 was due to transactions that were classified as fraud or error by you being auditor, audit planning and audit procedures tailored keeping in view the said assessment:

Response: While performing audit of the Company for year 2014 the auditors identified figure relating to year 2012 and 2013 were misstated. The auditors were given various explanations for reasons causing misstatement. Nature of some of journal entries indicate the possibility of intentional misstatement as the entries were unsubstantiated. Procedures were performed and tailored during conduct of audit for year 2014 (given in detail not stated here). Normal procedures were specifically tailored in response to situation that occurred in earlier years.

- c) *Issue:* Justify not modifying report if the auditors suspected fraud.

Response: As no instances of fraud were identified either by the management or suspected by us as a result of procedures performed during audit for year 2012 and 2013 therefore possibility of modification of audit opinion did not arise. Consequently, unqualified opinions were issued on financial statements of the Company for year 2013 and 2012. Since all the restatements were made by Company in accordance with accounting standards therefore unmodified opinion was issued for year 2014. There is no specific requirement under the ISAs for modification in the auditors' report if effect of restatements is appropriately accounted and disclosed in financial statements.



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- d) *Issue:* Audit procedures regarding internal control and risk assessment by the Company.
Response: In accordance with paragraph 12 of ISA 315, during the audit for year 2012 and 2013, the auditors performed procedures for obtaining understanding of the control environment of systems of the Company including those related to financial reporting, internal control structure and monitoring. The copy of working paper demonstrating work done w.r.t internal control of Company in context of audit of financial statement was also provided.
- e) *Issue:* Working papers that reflected that minutes of audit committee were reviewed and presence of risks to the Company or lack thereof were reviewed
Response: Working paper provided relevant to review of minutes of meetings of audit committee. The review of minutes did not highlight any instance, noting or observation relating to the matter that could have instigated any step other than those undertaken during normal course of audit.
- f) *Issue:* Risk mitigation measures assessed generally and with specific reference to migration to SAP over the years, staff resignation or any other risk specifically
Response: The Company started migrating to SAP during year 2009 and previous legacy system i.e. Quick book was also operating parallel to SAP. Various audit procedures were performed to check the valuation and completeness of inventory (procedures given). Also, resignation of former CFO and financial controller of the Company due to cash fraud made through manipulation of funds from the company's bank account. This fraud primarily relates to manipulation of funds for personal use and did not relate to unsubstantiated entries made. The matter was investigated by the audit committee and board as documented in their meeting's minutes.
- g) *Issue:* Specific audit procedures on journal entries keeping in view the requirements of ISAs in addition to those given in reply of the subject show cause notice
Response: Response of the auditor dated June 20, 2016 was referred. Procedures were performed in accordance with ISA 240 (not detailed in this order).



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h) *Issue:* Audit evidence of enquiries from individuals about inappropriate/unusual activities relating to processing of journal entries and other adjustments

Response: Inquiries were made with relevant personnel as to whether any inappropriate or unusual journal entries were made during the year. There were exceptions that warranted any additional procedures. Working paper provided.

i) *Issue:* Audit procedures for verifying adequacy of balances of liabilities specially regarding confirmation of creditors (foreign vendors) independent from company.

Response: Paragraph A51 of ISA 330 was referred in connection to planning procedures. As per judgment of engagement team members, it was concluded that instead of seeking direct confirmation from the foreign vendors of the Company for their outstanding balances with the Company as at the year end, the alternate audit procedures would comparatively be more effective and efficient. Details already provided in letters dated June 20, 2016. Working paper also provided.

j) *Issue:* Reconciliation of impact of restatement on profit & loss and EPS

Response: Details provided.

k) *Issue:* Audit procedures at the time of verifying the classification of balances

Response: For year 2012 and 2013 following procedures were performed:

- (i) Reviewed classification of each account balance, checking nature of each material account.
- (ii) Completed disclosure checklist for requirements of IFRS and fourth schedule to Ordinance

l) *Issue:* Any other evidence having bearing on the proceeding of the subject matter.

Response: We wish to highlight that as part of our audit procedures we reviewed audit reports issued by another firm to whom internal audit function was outsourced. Their report did not highlight any instance of fraud other than mentioned earlier. In general, internal audit assignments are more control focused and in depth in comparison to those conducted during statutory audits. Further after identifying discrepancies in foreign vendor liabilities balances,



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the management of the Company also engaged another accounting firm to ascertain independently the impact on the various ledger accounts during 2014.

10. In terms of notification S.R.O 1003(I)/2015 dated October 15, 2015 the power to adjudicate cases under Section 260 of the Ordinance has been delegated to Executive Director (Corporate Supervision Department).

11. Before elaborating the facts of the case, I would quote relevant paras of ISAs and Ordinance:

ISA 240: The auditor's responsibilities relating to fraud in an audit of financial statements

5. *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. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.*

6. *As described in ISA 200, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor.*

7. *Furthermore, the risk of the auditors not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.'*

8. *When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.*

12. *In accordance with ISA 200, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.*



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ISA 200: Overall Objectives of the Independent Auditor and the Conduct of an audit

15. *The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.*

ISA 315: Identifying and assessing the risks of material Misstatement

3. *The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.*

13. *When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel*

18. *The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:*

(a) *The classes of transactions in the entity's operations that are significant to the financial statements;*

(b) *The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements*

(c) *The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;*

(d) *How the information system captures events and conditions, other than transactions, that are significant to the financial statements;*

(e) *The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and*

(f) *Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.*

21. *In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT.*



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ISA 330: Auditor's Responses to Assessed Risks

10. In designing and performing tests of controls, the auditor shall:

(a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:

- (i) How the controls were applied at relevant times during the period under audit;
- (ii) The consistency with which they were applied; and
- (iii) By whom or by what means they were applied.

ISA 500: Audit Evidence

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence.

ISA 530: Audit Sampling

4. The objective of the auditor, when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

7. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Section 255 of the Ordinance prescribes powers and duties of the auditors, the manner, requirements and contents of auditors' report on the accounts. Rule 17 (A) of the Companies (General Provisions and Forms) Rules, 1985 requires that auditor's report shall be on prescribed format contained in Form 35-A.

Section 260 of the Ordinance states that,

"(1) If any auditor's report is made, or any document of the company is signed or authenticated otherwise than in conformity with the requirements of section 157, section 255 or section 257 or is otherwise untrue or fails to bring out material facts about the affairs of the company or matters to which it purports to relate, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document, and in the case of a



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firm all partners of the firm, shall, if the default is wilful, be punishable with fine which may extend to one hundred thousand rupees.

(2) If the auditor's report to which sub-section (1) applies is made with the intent to profit such auditor or any other person or to put another person to a disadvantage or loss or for a material consideration, the auditor shall, in addition to the penalty provided by that sub-section, be punishable with imprisonment for a term which may extend to 1[one year] and with fine which may extend to 2[one hundred] thousand rupees."

12. I have gone through the requirements of law, explanation provided by the Company and facts placed before me by the Department. In the order of incidence of events, I have observed the following:

a) Effect on financial statements:

As per the Note 4 of the accounts, balances relating to sales tax recoverable, LC margin, advances and liability for imported goods were previously misreported. The default of misreporting is admitted by the Company in the accounts. The restatement apart from misstatement of balances as at December 31, 2012 and December 31, 2013 has also resulted in decrease in reported Profit after Taxation (PAT) and Earning per Share (EPS) for the year ended December 31, 2013 as follows:

Particulars	Previously reported	Restated	Difference - overstated last year
	A	B	C = B - A
PAT - Rs. in Mln	209.156	25.394	(183.762)
EPS - Rupees	6.97	0.85	(6.12)

The decline due to restatement represents approximately 88% of previously reported PAT and EPS.

b) Reliance on internal control

The auditor is required to assess the effectiveness of internal controls employed by the Company in order to determine the extent to which reliance can be made by the Auditor on such internal controls. The submission's made by respondents do not reflect that ample weightage was assigned while determining the risk score to controls within the Company. Further, the respondents in their written



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reply as well as verbal submission have admitted that due their long term error free relationship with the company as auditors the audit was procedures were tailored on lower risk parameters. If internal controls are inadequate, which appears to be the case, then it is required extensive audit procedures and less reliance on internal controls. Auditor does not appear to have discharged this responsibility.

c) Audit procedures

It is important to state here that the purpose of referring observations from working paper was to have an overview of the approach of auditor with which the risk assessment was made, audit procedures were designed and performed. The Company has stated to rely on A&C score. As per the working papers the A&C score of 19 was given to the Company i.e. rated at lowest risk. The risk assessment tool will generate score based on the data fed in the system by engagement team. It appears that owing to faulty input of risk indicators in A&C software, low risk score for Company (and critical areas below) was generated and the auditor heavily relied on said score for preparing and performing audit procedures.

i. Inadequate audit procedures on Journal Entries:

The auditors have stated that they had checked a sample of journal entries, meeting specific criteria, based on their risk assessment and management representative in accordance with the requirements of ISA 580. The working paper provided reflected following results of audit procedures as per requirements of para 32 (a) of ISA 240. Following are important observations:

- a) The auditor has discussed the approach to journal entries. This implies that effects of migration to SAP and parallel system of Quick book as well in practice was not considered as high risk area or unusual activity.
- b) The auditor interviewed financial controller and no inappropriate or unusual activity was noted. This reflects that the alleged manipulation of funds that directly involves financial controller was not considered/identified as unusual activity or risk.
- c) The auditor concluded that in respect of para 32 (c) of ISA 240, based on management inquiry (from Mr. Rafiq, Financial controller) and other audit procedures no transaction was noted as significant transaction outside normal course of business. The matter of



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manipulation of funds by CFO and financial controller, its investigation by audit committee and reviewing minutes of Audit committee meeting was in knowledge of the auditors. This in itself is testament to the fact that presence of risk was not considered/ identified.

- d) The auditor also concluded that no other procedure was considered to be required in order to respond to the identified risks of management override of controls. Adequate procedures were not performed by the auditor on journal entries and the auditor failed to identify material adjustments made by the Company without underlying evidence. Moreover, auditor failed to either obtain adequate understanding of controls over journal entry process or design its audit procedures accordingly despite evident margin for potential compromises surrounding impeding SAP implementation and manual journal recording.

ii. Liability of imported goods:

The auditor relied on list provided by the company for sampling and verification by adopting percentage method of verification. Further, based on judgement of engagement team, direct confirmations from the foreign vendors of the Company for their outstanding balances with the Company as at the year-end were not obtained. Generally, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties is more reliable than evidence generated internally by the entity. Without going into details, audit procedures were insufficient and inadequate as external confirmations i.e. independent of company were not obtained. This defeats the purpose of independent audit and auditor's use of external confirmation procedures to obtain audit evidence stressed through ISA 330 and ISA 500 and dedicated ISA 505 regarding external confirmation.

iii. Cost of sales/ raw material consumption:

It is stated that auditors performed substantive analytics in accordance with ISA 520. It is also stated that the auditors verified a sample of raw material purchased during the year with underlying supporting documents. Nevertheless, considering the impact of



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reclassification on the profit and loss for the year 2013 the aforesaid should have been identified by the auditor.

d) Audit Sampling:

The auditor has relied predominantly on audit procedures by sample testing as per ISA 530. The objective of the auditor, when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected. Moreover, the ISA 530 further warns the auditors of sampling and non-sampling risks. Mere reliance on selected samples cannot exonerate the auditor of their responsibility to report on the adequacy of the Accounts of the Company.

e) Audit Evidence:

ISA 500, 'Audit Evidence' states that in order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. Performance of audit procedures on incomplete and accurate information produced by the entity would not enable the auditor to obtain reliable audit evidence. The management had stated that it was in process of migration to SAP from legacy system that led to such errors. The auditor has not mentioned that audit procedures in regard internal control environment or risks due to such migration. Also the parallel systems prior to migration, resignation of senior finance staff and multiple entries passed in SAP without supporting vouchers as admitted by the Company in itself poses risks and audit procedures were not designed to determine and address such risks and determine misreporting in accounts. Moreover, confirmations to creditors which provides information from sources independent of the company were not appropriately undertaken. The audit procedures performed by the auditor were not adequate enough to identify material misstatements at the financial statements level and at the assertion level. Audit procedures were also not adequate enough to ensure accuracy and completeness of balances and transactions. Consequently, affected the report issued by the auditor on the accounts for the year 2013 and 2012 of the Company.



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f) Professional skepticism

The objectives of auditor to identify and assess risk of material misstatement, obtain sufficient appropriate audit evidence regarding said risks. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence, and it is essential to the performance of effective audits. An auditor to required to maintain professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures are effective for detecting error may not be effective in detecting fraud. Moreover, this skepticism shall be maintained recognizing that circumstances may exist that cause the financial statements to be materially misstated. Meanwhile prime responsibility of the auditor is to bring out material facts and make a report thereof to the shareholders. Thus ISAs or the Ordinance does not exonerate auditor of its responsibility even in presence of fraud or error. The auditors did not sufficiently test or challenge management's views or representations to red flag areas that required cross verification, effects of lingering migration towards SAP or potential existence of deficiency of controls. Auditor should have exercised due diligence and performed additional procedures rather than merely relying on management's representations.

g) Fraud or Error

The covering regarding audit procedures provided by the Company state that they had planned the audit in accordance with ISAs and identified the risk of material misstatement relating to the fraud and error at the overall financial statement level and at the individual account balance level. The auditor initially contested that inherent limitation of detecting fraud as recognized by ISA 200 and subsequent discovery of material misstatement does not render failure to conduct audit in accordance with ISA. The auditor was specifically enquired if they considered that misstatements was owing to fraud. The response of auditor however is specific that no instances of fraud were identified either by the management or suspected by us as a result of procedures performed during audit for year 2012 and 2013. It was also contested that there is no specific requirement under the ISAs for modification in the auditors' report if effect of restatements is appropriately accounted and disclosed in financial statements.



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My question however remains if the auditors concluded during the course of audit for year 2014 that the restatement was due to error or fraud, was the same considered / discussed during audit with management or considered while drawing audit conclusion. Negligence of auditor is more grave if clean reports were issued despite knowledge of circumstances that auditor believed were related to fraud/ error (SAP, manipulation of funds, journal entries etc.). Therefore, it is viewed that shifting responsibility of carefully tailored audit procedures (keeping in view the risk and control environment of the entity) to mere inherent limitation of auditor in case of fraud or error fails the very purpose of audit.

h) Material Misstatement in Accounts

The Company has admitted misreporting in its accounts. The restatement apart from misstatement directly impacted profit and earning per share of the Company and was material. Thereby concluding that accounts of the Company for the year ended December 31, 2013 and 2012 were materially misstated. The auditors have not contested on materiality and impact of the restatement. Nevertheless, this in itself is a serious lapse of auditor's judgement, risk assessment and performance of audit in view his responsibility to make report to shareholders in accordance with the Ordinance.

13. I would like to emphasize that the role of auditor is critical in order to ensure that the financial accounts present true and fair view. The duties of the auditors have been stipulated in section 255 of the Ordinance and the relevant ISA's. The auditors have to act in a professional manner and their duty towards the shareholders and stakeholders should be that of a skilled professional and not a lay man. The argument of the respondent that the act was not willful has been examined in light of judgment in Jalaluddin F.C.A vs. Commissioner SEC 2005 CLD 333, where the meaning of willful has been discussed and it was held that: "whereas intent is a necessary ingredient of willfulness, impropriety is not. It is therefore not necessary to prove that the default committed by the Appellant was mala fide." Reliance is also placed on City Equitable Fire Insurance Co Ltd Re, 1925 Ch 407, referred to in 2005 CLD 333: "that a default, in case of breach of duty, will be considered 'wilful' even if it arises out of being recklessly careless, even though there may not be knowledge or intent."



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14. Internationally, auditors are facing severe implications for failure to exercise due professional skepticism and obtain adequate audit evidence thereby violating professional auditing standards. The duties of auditors can be observed in order of US Securities and Exchange Commission (US SEC) in matter of Ernst & Young LLP, Craig R. Fronckiewicz, CPA, and Sarah E. Adams, CPA dated October 18, 2016. US SEC observed that audit team despite high risk assessment, relied on Company's unsubstantiated explanations instead of performing the required audit procedures to scrutinize the company's accounting and failed to exercise due professional care and an attitude of professional skepticism. Further, in matter of India-based affiliates of PricewaterhouseCoopers (PwC) serving as Satyam Computer Services Limited, US SEC observed, "the failure to properly execute third-party confirmation procedures contributed to the fraud at Satyam going undetected for years".

15. A statutory auditor is bound to follow the requirements of the Ordinance, relevant Rules, ISAs and express an opinion using professional judgement and maintaining professional skepticism. Further auditor is required to identify and assess risks of material misstatements, obtain sufficient appropriate audit evidence and form an opinion based on conclusion drawn from such evidence. Moreover, in specific context of auditor's responsibilities in the audit of financial statements, the Ordinance is very vocal and clear. The auditors, by merely verifying that the reclassification of balances of previous years, is not expected to rubber stamping verifications. The auditors have also appeared to relied on representation of management owing to their long association with the Company as auditors. The purpose of rotation of auditor through code of corporate governance, highly debated, was put in place for purpose of reducing reliance or collusion. The duties and responsibilities of an auditor appointed by the shareholders under the law speaks of a custodian through which the shareholders seek an independent view as to how the directors have managed the affairs of the company. Further, audit of financial statements, being the foremost source of information for current and prospective investors, places auditor at a higher level of accountability and transparency. Therein the auditor is required to exercise due care and diligence in performing their duties and discharging their responsibility and maintain the trust and integrity.

16. For the foregoing reasons, I am of the view that the engagement partner in audit reports for year 2012 and 2013 failed to discharge his duties under the law by failing to exercise an attitude of



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professional skepticism, failed to perform the audit to obtain reasonable assurance whether the financial statements were free of material misstatement either due to error or fraud, failed to bring out material facts about the affairs of the company and make a report to the shareholders thereof. For the foregoing reasons, I am of the view that the engagement partner failed to perform his duties as envisaged under Section 255 and 260 of the Ordinance. In exercise of the powers under the Ordinance, I hereby conclude the proceedings with a stern warning to the engagement partner to be careful in future and ensure compliance of law in its true letter and spirit.

Abid Hussain
Executive Director
Corporate Supervision Department

Announced: December 23, 2016