Before Abid Hussain – Executive Director

In the matter of

M/s Hameed Chaudhri & Company
Auditor of Gulshan Spinning Mills Ltd

Number and date of notice:	No. CSD/ARN/193/2016 -963 dated September 20, 2016
Date of hearing:	October 21 2016
Present:	1. Muhammad Ali, Managing Partner, 2. Osman Hameed Chaudhri, Partner, M/s Hameed Chaudhri & Company, Chartered Accountants

ORDER

UNDER SECTION 260 (1) READ WITH SECTION 255 & 476 OF THE COMPANIES ORDINANCE, 1984

This order shall dispose of the proceedings initiated against the partners of M/s Hameed Chaudhri & Company, Chartered Accountants *(the "respondents")*, the auditors of Gulshan Spinning Mills Ltd *(the "Company")* through show cause notice *("SCN")* dated September 20, 2016, issued under the provisions of Section 260 and 255 read with Section 476 of the Companies Ordinance 1984 *(the "Ordinance")*.

2. Brief facts of the case are that examination of annual audited financial statements *("Accounts")* of the Company for the year ended June 30, 2014, audited by M/s Hameed Chaudhri & Company, Chartered Accountants *(the "Auditor")* revealed the following observations:

a) The Company on cessation of its associate relationship with Gulistan Textile Mills (GTM), reclassified the value of its investment in GTM from equity method to "investment at fair value through profit and loss" instead of charging it directly to retained earnings as required by para 41 of International Accounting Standard (IAS)- 16, "Property, plant and equipment" read with para 19A of IAS 28- "Investments in Associates".

b) As a result thereof loss of the Company, in the accounts for the year ended June 30, 2014, is understated by Rs. 179.672 million.

It was observed that the auditor of the Company failed to modify / qualify the Audit Report on the issue that the aforesaid treatment adopted by the Company is contrary to the requirements of IAS 28- "Investments in Associates" read with IAS 16- 'Property, Plant and Equipment'.

3. The auditor explained his position on above observations vide his letter dated May 17, 2016 that:

a. The gain of Rs. 179.672 million was recognized in accordance with Para 18 and 19 of IAS-28, Investment in Associates.

b. The Company, after cessation of associate relationship on 31.12.2013, recorded the investment in GTM on fair value and recognized the difference of fair value *(market price at PSX)* and carrying value of investment *(which was nil due to recognition of post-acquisition losses on equity method)*, in its profit and loss. The value of investment in GTM based on equity method contains *surplus on revaluation of fixed assets* of Rs. 170.057 million, which was included in the 'Surplus on revaluation of operating fixed assets' of the Company in its balance sheet. The fair value of investment at that date, which was Rs. 9.615 million, was added to the aforesaid amount and a total gain of Rs. 179.672 million was computed.

c. Further, it is pertinent to note that we have given an adverse opinion on the financial statements of the Company for the year ended June 30, 2014 through our report dated October 09, 2014.

4. The appropriate treatment as per requirements of International Accounting Standard ("IAS") 28, 'Investment in Associates' read with para 41 of IAS-16- Property, Plant and Equipment was that unrealized gain of Rs. 179.672 million for the year 2014 had to be transferred directly into 'retained earnings' instead of routing it through profit and loss account. The aforementioned contraventions prima facie, caused material misstatements in the accounts as reported loss after tax is understated by an amount of Rs. 179.672 million. Moreover, the Company has misreported in Note 2.1 to the Accounts 2014 that the Accounts are compliant with IFRS despite contraventions with IAS 28 in preparation of respective Accounts.

However, the Audit Report to the members of the Company dated October 9, 2014 failed to highlight material facts with respect to above matters contrary to the requirements of Section 255.

5. Based on the above, SCN was issued to the auditor dated September 20, 2016. The auditor replied to the contents of the SCN vide its letter dated October 7, 2016, which are summarized hereunder;

Gain on Discontinuation of Equity Method in Investment in Associated Company

a. The Company, after cessation of associate relationship as on December 31, 2013, recorded the investment in GTM on fair value in accordance with para 18 of IAS 28 – 'Investments in Associates' and recognized a gain of Rs.179.672 million.

b. The gain is the difference between carrying amount of investment computed on the basis of equity method (negative Rs.170.056 million) and the fair value (market price of GTM at Karachi Stock Exchange at that date) that is positive Rs.9.615 million.

Carrying value of Investment in GTM as per equity method

a. Numerical reconciliation of the carrying value of investments in GTM as per equity method along with comparative is tabulated below:

Particulars	As at Dec 31 2013 (Rs. In million)	As at June 30 2013 (Rs. In million)
(a) Cost	40.000	40.000
(b) Share of post-acquisition profit or loss		
At Beginning of the period	(217.122)	(191.834)
Share of loss for the period	-	(25.288)
At end of the year	217.122	(217.122)
(c) Share of item directly credited in the equity of GTM	7.066	4.825
(e) Value of investment based on negative equity of GTM	(170.056)	(172.297)
(d) Share of Surplus on revaluation of fixed assets of GTM	170.056	172.297

b. In accordance with the requirements of IAS 28 the Company's value of investment in GTM based on equity method consists of following four items of GTM:

(i) cost incurred by the Company at the time of acquisition;

(ii) the Company's share of post-acquisition profit or loss;

(iii) the Company's share of items directly credited in the equity of GTM; and

(iv) the Company's share of surplus on revaluation of fixed assets of GTM.

c. The management has recognized share of profit or loss in the Company's "Profit and Loss Account" under Equity Method and similarly movement in share of items directly credited in the equity by GTM is also taken to "Statement of Changes in Equity" of the Company.

Share of surplus on revaluation of fixed assets has been shown along with the Company's own 'Surplus on revaluation of operating fixed assets" in the balance sheet under the equity.

The management in preceding years has recognized share of losses of GTM in its 'Profit and Loss Account' to such an extent that its investment become nil in accordance with the paragraph 29 of the IAS 28 which states that if an investor's share of losses of an associate equals or exceeds its interest in the associate, the investor discontinues recognizing its share of further losses.

As the Company's carrying value of investment includes the share of surplus on revaluation of fixed assets of GTM, so the Company, in prior years, had charged share of losses of GTM in its 'Profit and Loss Account' to the extent of share of surplus on revaluation of fixed assets. Consequently reducing the carrying value of investment to negative figure, which can be assessed from abovementioned reconciliation {Ref. (e)}.

19A of IAS 28

If an investor loses significant influence over an associate, the investor shall account for all amounts recognized in ***other comprehensive income in relation to that associate on the same basis as would be required if the associate had directly disposed of the related assets or liabilities.*** *Therefore, if a gain or loss previously recognized in other comprehensive income by an associate would be reclassified to profit or loss on the disposal of the related assets or liabilities, the investor reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses significant influence over the associate. For example, if an associate has available-for-sale financial assets and the investor loses significant influence over the associate, the investor shall reclassify to profit or loss the gain or loss previously recognized in other comprehensive income in relation to those assets. If an investor's ownership interest in an associate is reduced, but the investment continues to be an associate, the investor shall reclassify to profit or loss only a proportionate amount of the gain or loss previously recognized in other comprehensive income.*

Paragraph 19A of IAS 28 has only described the treatment of such amounts which are recognized in other comprehensive income only. Accordingly, the treatment prescribed in this paragraph is not relevant in case of 'Surplus on revaluation of Fixed Assets'.

Further, the amount of Rs. 179.672 million suggested by your SCN for inclusion in equity is also not in accordance with paras cited in SCN. In that case amount to be recorded in equity would have been Rs. 170.056 million and a gain of Rs.9.615 million in profit and loss account. It appears that our reply to letter no. EMD/233/130/2002-1095 bearing reference no.45/G-19/2016 has not been considered and our reply has only been partially reproduced in the SCN.

Failure to disclose material fact

We would like to make the following submission:

i) Materiality

Para 2 of International Standard on Auditing - 320 "Materiality in Planning and Performing an Audit" define the basis of materiality and explain that:

- Misstatements, including the omissions, are considered to be material if they, individually or in the aggregate, could be reasonably be expected to influence the economic decision of user taken on the basis of financial statements;
- Judgements about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effects of misstatements on specific individual users, whose needs may vary widely, is not considered."

Following factors are important in considering the materiality in case of Company;

- Gross loss incurred during 2014- Rs.332.523 million;
- Accumulated losses in 2014 were Rs.2,390.323 million;
- Shareholders' equity is negative by Rs.1,896.07 million;
- Current liabilities exceeded its current assets by Rs.2,536.04 million;
- Filing of filed recovery suits by banks;
- Inappropriate going concern assumption used in the preparation of the financial statements; and
- Mark-up / interest on long-term finances, lease finances and short-term borrowings to the extent of Rs.837.82 million had not been accrued.

Based on above facts disclosed in financial statements and adverse audit report thereon an entry of Rs.179.672 million (as per SCN) and its impact on financial statements, especially, on loss per share taken as a whole in the given circumstances will technically be not material and seems meaningless.

ii) Adverse Opinion on Financial Statements

We have modified our audit report and expressed an "Adverse Opinion" on the financial statements of the Company for the year ended June 30, 2016.

Complying with the requirements of section 260 of the Ordinance, we have clearly brought material facts about the affairs of the Company to the notice of users of the financial statements. The Auditors' intent, professionalism and independence are quite evident from the type of modification to the opinion in accordance with the provision of ISA 705. In view of our above submissions you are requested to consider withdrawal of the said SCN.

6. In order to grant an opportunity to the respondents to explain their position in the matter, hearing was fixed on October 20, 2016. Mr. Muhammad Ali and Osman Hameed Chaudhri, Partners of the audit firm attended hearing and reiterated the same arguments as were submitted in their reply to the SCN. They submitted

7. Before proceeding further, it is necessary to advert to the following relevant provisions of Ordinance:

Section 255 (3) of the Ordinance prescribes requirements and the manner of auditor's report on the Accounts:

> *"(3) The auditors shall make a report to the members of the company on the accounts and books of accounts of the company and on every balance-sheet and profit and loss account or income and expenditure account and on every other document forming part of the balance-sheet and profit and loss account or income and expenditure account, including notes, statements or schedules appended thereto, which are laid before"*

Section 260 of the Ordinance states as under:

> *"(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 firm all partners of the firm, shall, if the default is willful, be punishable with fine which may extend to one hundred thousand rupees.

In terms of the Commission's notification SRO 1003 (I)/2015 dated October 15, 2015, the powers to adjudicate cases under section 260 have been delegated to the Executive Director (Corporate Supervision Department).

7. I have analyzed the facts of the case, relevant provisions of the Ordinance, arguments put forth by the representative during the hearing and observed that the respondent could have demonstrated more cautious approach towards reporting the instant issue in its audit report giving an adverse opinion on the accounts of the Company. The transfer / recognition of Company's investment in GTM to retained earnings instead of "Investment at fair value through profit and loss" is required by para 41 of IAS 16 - "Property, plant and equipment" read with para 19A of IAS 28 - "Investments in Associates". Para 19 A was referred here as it provides guidance on correct treatment of afore referred Company's share of surplus on revaluation of fixed assets of GTM. The Company has wrongly charged the share of losses of GTM in its Profit and Loss Account to the extent of share of surplus in revaluation of fixed assets, consequently reducing the carrying value of investment to negative figure. The disclosure made by the Company has distorted the entire picture where the already accumulating losses were understated by an amount of Rs. 179.672 million. The auditor failed to highlight this deviation having an adverse impact on the performance snapshot of the company i.e. Profit and Loss Account.

8. In our socio-economic environment chartered accountants, who act as auditors of listed and other companies enjoy a position of great respect. Accounts audited by them carry a weight and are relied upon by various authorities and stakeholders. They are often called upon by different authorities including stakeholders and also by international organizations, to certify various financials of the companies, as a means to provide due comfort to these authorities, stakeholders and organizations for their intended purposes. For these reasons, it is further more

important for the auditors to exercise due diligence in performing their duties and discharging their responsibilities and maintain a high level of trust and integrity at their end.

9. Keeping in view the accounting treatment of the afore-referred amounts by the Company and the pursuant compulsion faced by the auditors, I, based on the submissions of the auditor, close the matter without any adverse order.

Abid Hussain
Executive Director

Announced:
January 10, 2017
Islamabad