<u>Before Mr. Tariq Bakhtawar, Director Enforcement</u>

In the matter of

M/s Kamran & Co. Chartered Accountants

<u>Under Sub-Section (1) of Section 260 Read With Section 255 and 476 of the Companies Ordinance 1984</u>

Number and date of notice	No. EMD/233/541/2003-6575 dated Dec. 21, 2005
Date of hearing	March 20, 2006
Present	Mr. Wasim Barkat, Assistant Manager, Kamran & Co., Chartered Accountants
Date	May 02, 2006

ORDER

This order shall dispose of the proceedings initiated against M/s Kamran & Co., Chartered Accountants (hereinafter referred to as the "Auditors") through show cause notice dated December 21, 2005 under sub-section (1) of Section 260 read with Section 255 and 476 of the Companies Ordinance, 1984 (the "Ordinance") for making report to the members of M/s Morafco Industries Limited (hereinafter referred to as the "Company") on the accounts and books of accounts and balance sheet and profit and loss account otherwise than in conformity with the requirements of Section 255 of the Ordinance.

2. M/S Kamran & Co., Chartered Accountants is a sole proprietary firm and the partner Mr. Kamran Fatah, FCA is a practicing member of the Institute of Chartered Accountants of Pakistan (the "ICAP").

3. In order to fully appreciate the issues involved in this case brief narration of the background facts is necessary. M/s Kamran & Co., Chartered Accountants were appointed as auditors of the Company in its Annual General Meeting held on November 11, 2004 to hold office until the conclusion of next Annual General Meeting. The auditors have audited the accounts and books of accounts of the Company and have made audit report on the financial statement of the Company for the year ended June 30, 2005 (the "Accounts").

4. The Enforcement Department conducted an examination of the financial statements of the Company for the year ended June 30, 2005 to determine, among other things, whether Auditors' report pertaining to the aforesaid financial year had been made in conformity with the requirements of Section 255 of the Ordinance, is otherwise true, contains no such statement which is materially false and there is no omission of material facts about the affairs of the company.

5. The examination of the audited accounts of the Company for the year ended June 30, 2005 revealed that the auditors have failed to discharge their duties with regard to following deficiencies and irregularities.

5.1) Going Concern:

Examination of audited accounts of the Company revealed that the manufacturing activity of the Company had been closed since the year 1997. As on September 30, 2005, its accumulated losses stood at Rs.837 million which resulted in net capital deficiency of Rs.825.758 million. These circumstances gave rise to significant doubt regarding the Company's ability to continue as a going concern. It was stated by the management itself in Note 2.2 of the accounts **that the Company is no longer considered to be a going concern** and no explanation was given by the management regarding appropriateness of using going concern assumption in preparation of the accounts**.** However, the accounts were prepared on going concern basis and **yet the auditors did not modify their opinion to give an adverse opinion** as provided in Para 35 of International Standard on Auditing (ISA)-570. The directors did not give any reasonable indication of future prospects for profits and the revival of the Company as justification for preparing accounts on going assumption rather; plans for privatization of the unit were disclosed in Director's Report as follows:

"Ministries of Industries and Production have already requested the Privatization Commission (PC) for inclusion of Morafco Industries Limited, Faisalabad in their Privatization program. The Board of Directors of PC and Cabinet Committee on Privatization have also approved the privatization of this unit. The evaluation and other formalities are in process with the privatization commission. It is expected that the PC will be able to privatize this unit during the current financial year."

It was thus evident that the Company was not a going concern on the date of audit report, but still accounts prepared on going concern basis without any justification as such by the management and did warrant an adverse opinion in auditors' judgment.

5.2) Reference to the previous Auditor's Report:

The accounts of the company for the year ended June 30, 2004 were audited by another auditor M/s Javaid Jalal Amjad & Co. Chartered Accountants, who in their report dated October 13, 2004 had expressed ***an adverse opinion*** on those financial statements due to invalid going concern assumption. However, the auditors while auditing the accounts of the current year have failed to report emphasis of matter paragraph regarding the substantive reasons for expressing an opinion different from that expressed on previous years' accounts, when the matter that gave rise to the modification is unresolved, as provided in Para 17 of ISA-710.

5.3) True and fair view of the state of Company's affairs:

The auditors in their report to the members of the Company have expressed a clean opinion on the accounts in spite of the fact that the Company was not a going concern on the date of audit report, but accounts were prepared on going concern. The audit opinion was as follows:

"In our opinion and to the best of our information and according to the explanations given to us, the Balance Sheet, Profit and Loss Account, Cash Flow Statement and Statement of changes in equity together with the notes forming part thereof conform with approved accounting standards as applicable in Pakistan, and, give the information required by the Companies Ordinance, 1984, in the manner so required and ***respectively give a true and fair view of the state of the Company's affairs as at June 30, 2005*** *and of the profit, for the year then ended."*

While, the auditor's review report to the members on the statement of compliance with best practices of Code of Corporate Governance expressed the same in the following way:

"…The financial statements have been prepared on a "going concern" basis, <u>which in no way, represents the true state of affairs of the company</u>, and don't comply with appropriate accounting policies…"

The above contradictory statements were made by the auditors of the company for the period ended June 30, 2005. Adverse audit opinion is expressed in review report on statement of Compliance with best practices of Code of Corporate Governance while emphasis of matter paragraph is provided in the audit opinion.

6. In view of the above, the Enforcement Department got concerned with regard to the quality of audit of the Company conducted by the Auditors and the audit report given by them on the Accounts of the Company for the year ended June 30, 2004. It was observed that the Company had not justifiably explained the appropriateness of using Going Concern assumption in preparation of the Accounts and the Auditors failed to express adverse opinion regarding validity of going concern assumption as per International Standards on Auditing applicable in Pakistan.

7. Consequently, a show cause notice was issued to the auditors of the company M/s Kamran & Co., Chartered Accountants, on December 21, 2005 pointing out their responsibilities under the Ordinance, International Accounting and Auditing Standards and non-compliance observed in the Accounts of Morafco Industries Ltd. A period of 14 days was given to respond to the aforesaid notice. Subsequently, the reply was received on February 13, 2006 with a delay of 40 days. In order to provide an opportunity of personal hearing, the case was fixed for March 03, 2006. Subsequently auditors sought extension and were advised to appear for hearing on March 20, 2006 on which date Mr. Mr. Wasim Barkat, Assistant Manager, Kamran &Co. Chartered Accountants appeared before me at the time of hearing and argued the case. The submission made by him against the SCN are summarized as under:

7.1) Going Concern:

The auditors in support of their opinion submitted that they have expressed correct opinion on the accounts of the Company for the aforesaid year in the following manner:

"As stated in note 2.2 the Company's current liabilities exceed its current assets and hence the Company has ceased to be a going concern. Consequently, it is not in a position to realize its assets and discharge its liabilities in the normal course of business. <u>The enclosed financial statements are stated at historical cost instead of net realizable value.</u>"

Note 2.2 discussed the going concern assumption in the following way:

"The Company has incurred a net loss of Rs.1,125 thousands during the year (2004:1671 thousands) and accumulated loss is to the tune of Rs.837,087 thousands (2004:835,962 thousands). The Company's current liabilities exceed its current assets by Rs.828,337 thousands (2004: Rs. 827,500 thousands) and <u>the Company has ceased its operations since 1997. These events clearly demonstrate that the Company is no more a going concern.</u> Privatization Commission (PC) offered the Company's assets for sale but the reserve price set by PC was not received. The major shareholding Company (GCP 43%) is presently financing the Company to meet the current requirements."

The auditors also stated that the Auditor's report to the members of the company is duly qualified and conveys the circumstances leading up to the assumption that the company is no more a going concern.

7.2) Reference to the previous Auditor's Report:

Auditors have argued that the opinion expressed by them is exactly the same as that expressed by the previous auditors on previous year's financial statements i.e. the company is no more a going concern and that it is unable to realize its assets and liquidate its liabilities. Therefore, according to them their audit report on current year accounts is in no way misleading, as material facts have been duly disclosed and stated on the face of the Auditor's Report.

7.3) True and fair view of the state of Company's affairs:

Auditors have stated that the issue of true and fair state of affairs of the company is thoroughly discussed in the *Review Report to the members on statement of compliance with best practices of code of corporate governance*, but the same was unintentionally overlooked in the Auditor's Report. They have requested to condone the same.

8. I have taken into consideration the submissions, made in writing as well as those at the time of haring of this case and I am of the view that most of the grounds taken by the Auditor are not convincing due to the following reasons:

8.1) Going Concern

The Auditors' reservation on the going concern matter is a modification in the form of emphasis of matter paragraph as per Para 33 of ISA 700 that does not affect the Auditors' opinion. The said modification is wrongly contended by the Auditor as a qualification which is proved incorrect, as a qualified opinion should be expressed as being "except for" the effects of the matter to which the qualification relates as provided in Para 37 of ISA -700.

In the auditors report to the members, the auditors have admitted that the audit has been conducted in accordance with the auditing standards as applicable in Pakistan. However, in this particular case they have not expressed their opinion in accordance with the ISAs.

It has also been noted in the directors' report dated October 18, 2005 that observations of Auditors in audit report on the going concern issue have not been explained by directors.

Para 24 of IAS-1 (Presentation of Financial Statements) states:

"In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which is at least, but is not limited, to twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an enterprise has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate maybe reached without detailed analysis. In other cases, management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy that the going concern is appropriate."

The directors in their report have categorically stated that "*the Company sustained a net loss of Rs.1.125 million during the year against Rs.1.671 million in the year 2004. The Company's current liabilities exceed its current assets by Rs. 828.337 million (Rs. 827.500 million in 2004). These events already demonstrate that the Company is no more a going concern. The major shareholding company Ghee Corporation of Pakistan holding 43% shares in the company is presently financing the Company to meet its current requirements for last several years".*

It is clear that as per the management's assessment the going concern assumption for preparation of accounts is absolutely invalid, yet the financial statements were prepared on a going concern basis.

In this regard, Para 23 of IAS-1 states:

"Financial statements should be prepared on going concern basis unless management either intends to liquidate the enterprise <u>or to cease trading</u>…"

The audit opinion stating that accounts give a true and fair view of the state of affairs of the Company in afore referred scenario is thus incorrect and misleading. Therefore, the plea of the auditors that the Audit report is duly qualified and conveys the circumstances leading up to the assumption that the company is no more a going concern is not tenable.

Para 35 of ISA-570 requires that *if in the judgment of the auditor the entity will not be able to continue as a going concern, the auditor **should express an adverse opinion** if the financial statements have been prepared on a going concern basis.*

The auditors thus, while forming their opinion failed to comply with the relevant ISAs.

8.2) Reference to the previous Auditor's Report:

The Auditors response that the opinion expressed by them is exactly the same as expressed by the previous Auditors is not justifiable. The opinion paras of two reports are reproduced as follows:

"Because of the significance of the matter discussed in Para 1.1 (going concern issue), in our opinion and to the best of our information and according to the explanations given to us, the Balance Sheet, Profit and Loss Account, Cash Flow Statement and Statement of changes in equity together with the notes forming part thereof do not conform with approved accounting standards as applicable in Pakistan, and <u>respectively do not give a true and fair view of the state of the Company's affairs as at June 30, 2004</u> and of the loss, its cash flows and changes in equity for the year then ended."

"In our opinion and to the best of our information and according to the explanations given to us, the Balance Sheet, Profit and Loss Account, Cash Flow Statement and Statement of changes in equity together with the notes forming part thereof conform with approved accounting standards as applicable in Pakistan, and, give the information required by the Companies Ordinance, 1984, in the

manner so required and respectively give a true and fair view of the state of the Company's affairs as at June 30, 2005 and of the profit, for the year then ended."

It is apparent that the current year audit opinion is clean as merely emphasis has been drawn towards the going concern uncertainty while prior year opinion was adverse. The audit report is thus misleading as according to the IAS difference of the opinion has not been justified.

8.3) True and fair view of the state of Company's affairs:

The auditors have admitted the default on the issue of their clean opinion about the state of affairs of the company and argued that the same was unintentionally overlooked in the Auditor's Report. Since the auditors have admitted the default, therefore, the issue needs no deliberation.

8. On the foregoing, I am convinced that the going concern assumption was not appropriately used by the management and the Auditors in spite of having sufficient audit evidence have failed to express adverse opinion in their report accordingly.

9. Before deciding this case, I deem it necessary to make some observations on the role of Auditors of a Company. The auditors being the ultimate watchdog of the shareholders interest are required to give a report on the accounts and books of account after conducting the audit in accordance with the prescribed procedures and requirements of the Ordinance, International Accounting and Auditing Standards. If they find any irregularity, which is material with regard to those accounts, they are required to issue a qualified report. The shareholders are the ultimate entity to whom the Auditors are responsible and they must keep this fact in mind while auditing the books of accounts and reporting thereon. It has, however, been noticed in several cases that Auditors are not performing their statutory duties with due care and in accordance with the legal requirements. They must realize their true role and restrain themselves from performing their duties indulgently.

10. The duties and responsibilities of an Auditor appointed by the shareholders under Section 252 of the Ordinance can best be understood if we look at the place of an auditor in the scheme of the company law. The capital required for the business of a company is contributed by its shareholders who may not necessarily be the persons managing the company. In the case of a listed company, the general public also contributes towards the equity of the company. Such persons do not have any direct control over the company except that they elect directors for a period of three years and entrust the affairs of the company to them in the hope that they will manage the company to their benefits.

The shareholders are, therefore, the stakeholders and the ultimate beneficiaries. Practically, however, the shareholders have no control over the way their Company is managed by the directors appointed by them. It was, therefore, necessary that there must be some arrangement in place whereby the shareholders who are the real beneficiaries must get some independent view as to how the directors have managed the affairs of the company. The law, therefore, recognizing this situation, has provided that the shareholders should appoint an auditor who shall be responsible to audit the accounts and books of account and make out a report to them at the end of each year. This is the only safeguard provided by law to the shareholders to ensure that the business is carried on by the directors in accordance with sound business principles and prudent commercial practices and no money of the company is wasted or misappropriated. The law, therefore, make the auditors responsible in case they failed to make out a report in accordance with the legal requirements. It is, therefore, extremely important for the auditors to be vigilant and perform their duties and obligation with due care while auditing the accounts and books of accounts.

11. Now reverting to the present case, it is clear from the preceding paragraphs that the auditors had failed to perform their statutory obligations by giving contradictory and misleading information to the members and, in this way, had failed to perform their professional duties with reasonable degree of care and skill. They knowingly and recklessly ignored their observations and gave a clean bill of health to the Company's accounts. Auditors' statement that the issue of true and fair unintentionally overlooked in the Auditor's Report itself speaks about the quality of audit as the most important aspect i.e. reporting was not given due importance. It is therefore viewed that the auditors have committed a breach of fiduciary duty cast upon them by the shareholders.

12. After careful consideration of the conduct of the auditors of the Company and the circumstances of this case, I am of the view that Mr. Kamran Fatah, proprietor of M/s Kamran & Co., Chartered Accountants, has signed the audit report otherwise than in conformity with the requirements of Section 255 of the Ordinance and has made himself liable for punishment under Sub-section (1) of Section 260 of the Ordinance.

13. For the reasons stated above, I impose a fine of Rs.25, 000 (Rupees Twenty five thousand) under Sub-section (1) of Section 260 of the Ordinance on proprietor of M/s Kamran & Co., namely, Mr. Kamran Fatah for making report otherwise than in conformity with the requirements of Section 255 of the Ordinance on the financial statements of the Company for the year ended June 30, 2005.

14. Mr. Kamran Fatah is directed to deposit the fine of Rs 25,000 (Rupees twenty five thousand only) in the Bank Account of Securities and Exchange Commission of Pakistan maintained with Habib Bank Limited within 30 days of the date of this Order and furnish receipted bank voucher to the Securities and Exchange Commission of Pakistan.

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Tariq Bakhtawar
Director Enforcement