Securities and Exchange Commission of Pakistan
Enforcement and Monitoring Division

[Islamabad]

Before Rashid Sadiq, Executive Director

Order

In the matter of
M/S Saleem Ahsan & Co. Chartered Accountants
[UNDER SUB-SECTION (1) OF SECTION 260 OF THE COMPANIES ORDINANCE, 1984]

Number and date of notice	EMD/C.O.233/EA/595/2002 November 14, 2002
Date of hearing	December 03, 2002
Present	Mr. Muhammad Saleem Ahsan, FCA
Date of Order	June 27, 2003

This Order shall dispose of the show cause proceedings initiated against M/S Saleem Ahsan & Co. Chartered Accountants under Section 260 of the Companies Ordinance, 1984 (the "Ordinance").

2. Mr. Muhammad Saleem Ahsan and Mr. Haroon Nasim are members of the Institute of Chartered Accountants of Pakistan (the "ICAP') and their registration numbers are 1739 and 2076 respectively. They are partners of the firm namely, M/S Saleem Ahsan & Co. and the firm has offices in Lahore and Islamabad.

3. The facts leading to this case, briefly stated, are that M/S Saleem Ahsan & Co., Chartered Accountants were appointed as auditors of M/S Diamond Industries Limited (the "Company") in its Annual General Meeting held on December 27, 2001 to hold office from the conclusion of the said meeting until the conclusion of next Annual General Meeting. The Enforcement and Monitoring Division has conducted an examination of the financial statements of the Company for the year ended June 30, 2002 (the "Accounts") to determine, among other things, as to whether the Auditor's Report pertaining to the aforesaid financial year has been made in conformity with the requirements of Section 255, is otherwise true, contained no statement, which is materially false and that there is no omission of material facts about the affairs of the Company.

4. The aforesaid examination of the Accounts indicated that the Company has not observed the requirements of the following International Accounting Standards (IAS) and Fourth Schedule to the Ordinance with regard to the accounts and preparation of the Balance Sheet and Profit and Loss Account for the year ended June 30, 2002:

(i) Depreciation has not been provided on plant and machinery valuing Rs. 86.014 million against the requirements of paras 41 and 42 of International Accounting Standard 16 (Property, Plant and Equipment).

(ii) Depreciation of Rs. 4.899 million on revalued portion of building, plant and machinery has been adjusted against surplus on revaluation of fixed assets instead of charging the same to profit and loss account as per requirements of Section 235 of the Ordinance (Note 5 to the accounts).

(iii) Statement of changes in equity has been included in the notes to the accounts contrary to the requirements of Para 7 of IAS 1(Presentation of Financial Statements), which requires that separate statement of changes in equity to be prepared and annexed to the accounts.

(iv) The Company has not provided loss of Rs. 9.975 million arising from changes in fair value of the assets as per requirements of Para 69 of International Accounting Standards 39 (Financial Instruments; Recognition and Measurement).

(v) Disclosure of financial instruments as per Paras 56, 66 and 77 of IAS 32 (Financial instruments: Disclosure and Presentation).

(vi) Dividend income has been offset against capital loss on sale of investment against the requirements of International Accounting Standards 1 and 32 (Financial instruments: Disclosure and Presentation).

(vii) Disclosure of staff retirement benefits according to Para 120 of International Accounting Standard 19 (Employee Benefits).

(viii) Disclosure of shares held by associated undertakings in the share capital of the Company as per Para 74 of IAS 1 (Presentation of Financial Statements).

(ix) Disclosure of earnings per share as per Para 47 and 49 of IAS 33 (Earnings Per Share).

(x) Disclosure of number of employees as per Para 102 (d) of IAS-1 (Presentation of Financial Statements);

(xi) Accounting policy of borrowing cost as per para 9 of IAS 23(Borrowing Costs).

(xii) Reason of low output as per Sub-para (VII) of Para 2 of Part I of the Fourth Schedule to the Ordinance.

5. It was also noticed from the perusal of the Accounts that the Company has disclosed under Contingencies and Commitments (Note 9) that the shares of the company were lying with Muhammad Hanif Moosa, a member of the Karachi Stock Exchange (the ‘KSE”) who was declared defaulter and all his assets with the Exchange were sold. The company had filed a claim against KSE for an amount of Rs. 488.83 million for sale of company’s shares, which were in the custody of the said member. It was observed that these shares had never been disclosed in the accounts since year 2000. M/S Saleem Ahsan & Co., had been the auditor of the Company for the last several years, however, they have not draw attention of the members of the Company towards this issue in their reports on the Accounts.

6. In view of the above deficiencies, the audit report on the Accounts was perused and it was observed that the auditors of the Company, have not drawn attention of the members towards the aforesaid deficiencies in their audit report

signed on October 07, 2002 and instead have given an opinion that the balance sheet, profit and loss account together with the notes thereon have been drawn up in conformity with the Ordinance and gave a true and fair view of the state of the Company's affairs. It was further represented by the auditors that the balance sheet, profit and loss account, cash flow statement and statement of changes in equity together with the notes forming part, thereof conformed with the approved accounting standards as applicable in Pakistan and give the information required by the Ordinance in the manner so required.

7. In view of the above circumstances, the Enforcement Division felt concerned about the quality of audit conducted by M/S Saleem Ahsan & Co., Chartered Accountants and the report made by them on the Accounts. It was decided to investigate the matter further to bring to light as to whether or not the representations and statements made by the auditors to shareholders, investors and general public were misleading and false.

8. Consequently, a notice dated November 14, 2002 was issued to both partners of the firm namely, Mr. Muhammad Saleem Ahsan and Mr. Haroon Nasim pointing out clearly their responsibility under the Ordinance, International Accounting and Auditing Standards and the *prima facie* false and misleading statements made by them in their report on the Accounts of the Company. They were called upon to show cause as to why action may not be taken against them for the contraventions of the mandatory provisions of law. The Auditors did not respond to the aforesaid show cause notice. In order to provide an opportunity of personal hearing, the case was fixed on December 03, 2002 on which date Mr. Muhammad Saleem Ahsan appeared and argued the case. He also submitted a written reply to the show cause notice.

9. In the written submissions as well at the time of hearing of this case, Mr. Muhamamd Saleem Ahsan admitted that some of the disclosures as pointed out in show cause notice were lacking in presentation of Accounts of the Company for the year ended June 30, 2002. He also stated that he was the engagement partner for the audit of the Company for the year ended June 30, 2002 and had signed audit report on the Accounts. He pleaded for a lenient view of the defaults and assured compliance of the statutory provisions in future. I have carefully considered the arguments of Mr. Muhamamd Saleem Ahsan and it is necessary for me to deliberate on each issue as under:

i) I do not agree with the argument that depreciation on the plant at Gadoon Amazai has not been provided because the plant has been closed due to withdrawal of government incentives in the area and the Company is in process of deciding the fate of that plant. In this regard, para 41 of IAS 16 is relevant which provides that the depreciable amount of an item of property plant and equipment should be allocated on a systematic basis over its useful life. The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. Further, ATR 14 provides that fixed assets abandoned but not physically disposed of and equipment still owned with no apparent likelihood of resuming operations, if material in amount, should be removed from fixed assets and recorded separately at <u>lower of cost and estimated realizable amount</u>, appropriately explained. As the plant was closed and no depreciation was charged, it was the duty of the Auditors to have modified their report to the members of the Company.

ii) As for adjustment of depreciation against surplus on revaluation of fixed assets is concerned, the contention that adjustment of depreciation on revalued portion of assets has been allowed by recent amendments in the Ordinance is not acceptable as the said amendments were introduced on October 26, 2002 after the audit report was signed on October 07, 2002. I have perused the earlier Accounts signed by the auditors and noticed that the Company made similar adjustment of depreciation against surplus on revaluation of fixed assets in the year 2001 also. Therefore, the arguments of Mr. Muhamamd Saleem Ahsan do not carry any force. The auditors, therefore, were required to bring this material fact to the notice of the members in their report.

iii) With regard to contingency related to shares of Rs. 488.83 million, it was stated that this represented claim filed against KSE on account of shares lying with Muhammad Hanif Moosa, the defaulted member of KSE. This amount was calculated on April 2000 and included unrealized gains on such investments. The cost of such investments was much less and has already been provided for in the accounts of respective years. It was the contention of Mr. Muhammad Saleem Ahsan that the probable outcome of the claim would result in income for the Company and, therefore, would not have any negative effect and the disclosure given by the Company was in accordance with the requirements of IAS 37. I am of the view that first of all the gain of Rs 488.83 million was not recognized in the Accounts by the Company and secondly, the shares represented by this gain were not found disclosed in the Accounts. In view of this fact of the matter, the auditors have failed to bring this material fact about the affairs of the Company to the knowledge of the members of the Company. It was their duty to have modified their report to the members.

iv) I also do not agree to the contention that the statement of changes in equity disclosed in note 4 to the accounts was sufficient. The mandatory provisions of law require that such statements should be a separate component of the financial statements.

v) No satisfactory reply was given by Mr. Muhamamd Saleem Ahsan on the issue that the Company has not recognized the diminution in value of short term investments amounting to Rs.9.975 million. In this regard, Para 69 of International Accounting Standards 39 (Financial Instruments; Recognition and Measurement) is most relevant which requires that after initial recognition, <u>an enterprise should measure financial assets at their fair value</u> without any deduction for transaction costs that it may incur on sale or disposal. Therefore, the short term investments were overstated by aforesaid amount and the auditors have failed to modify their opinion with regard to non-compliance of IAS 39 and truth and fairness of the accounts.

vi) As regards to other deficiencies in disclosure of financial instruments as per IAS 32, offsetting of income and expenses against the requirement of IAS 1 and IAS 32, Staff Retirement Benefits as per IAS 19 and accounting policy of Borrowing Costs, etc., Mr. Muhamamd Saleem Ahsan admitted some of the them while no satisfactory reply was given to rest of the issues. He, however, assured that he would address these issues in future years.

10. In view of the above discussion, it is abundantly clear that the auditor has failed to perform their statutory obligations by not giving fullest information to the members. It is apparent that they have conducted their audit too indulgently. It was incumbent on the Auditor to have drawn attention to the members of the Company towards the non-compliances/ contraventions in his Audit Report. In the circumstances, it is clear that the Auditor has failed to perform his duties with reasonable degree of care and skill. Their statements and representations in their report were, therefore, false and misleading. The audit report made was otherwise than in conformity with the requirements of section 255 of the Ordinance and had failed to bring material facts about affairs of the Company.

11. 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 modified 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. They must realize their true role and restrain themselves from performing their duties indulgently.

12. 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 fail to make out a report in accordance with the legal requirements. It is, therefore, important for the auditors to be vigilant and perform their duties and obligation with extreme care while auditing the accounts and books of accounts.

13. In view of the above, the lapses, irregularities and non-compliances on the part of the auditors cannot be taken lightly. After careful consideration of the conduct of the auditors of the Company and the particular circumstances of this case, I am of the view that no justice would be done to issue warning only as pleaded by Mr. Muhammad Saleem Ahsan during the course of hearing of this case. As the Auditor has admitted the defaults and has not been able to give any justifiable excuse for the same, therefore, I consider it a deliberate act which is certainly more than mere omission and default on the part of Mr. Muhammad Saleem Ahsan who was under legal obligation to perform his duties, in the course of audit of Accounts of the Company and reporting thereon, in accordance with the provisions of the Ordinance, International Accounting Standards and Auditing Standards. Mr. Muhammad Saleem Ahsan has, therefore, made himself liable for punishment under Sub-section (1) of Section 260 of the Ordinance.

14. For the forgoing, I impose a fine of Rs.2,000 (Rupees two thousand) under Sub-section (1) of Section 260 read with Section 476 of the Ordinance on Mr. Muhammad Saleem Ahsan only. As Mr. Muhammad Saleem Ahsan has assumed the full responsibility of signing the report, therefore, no fine is imposed on Mr Haroon Nasim, the other partner.

15. Mr. Muhammad Saleem Ahsan is directed to deposit the above stated fine 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 a receipted challan to the Securities and Exchange Commission of Pakistan.

16. A copy of this Order may also be sent to President, ICAP for his information and necessary action in accordance with the provisions of the Chartered Accountants Ordinance, 1961.

RASHID SADIQ
Executive Director (Enforcement & Monitoring)

Announced
June 27, 2003
ISLAMABAD