



Securities and Exchange Commission of Pakistan
Enforcement and Monitoring Division

[Islamabad]

Before Rashid Sadiq, Executive Director

In the matter of
MR. MUHAMMAD SARFRAZ, FCA

Number and date of notice	EMD/CO.265/260/2002-3534 July 30, 2002
Date of hearing	December 02, 2002
Present	Mr. Muhammad Sarfraz, FCA
Date of Order	April 29, 2003

This Order shall dispose of the show cause proceedings initiated against Mr. Muhammad Sarfraz, a practicing Chartered Accountant who is the auditor of M/S Regal Ceramics Limited (hereinafter referred to as the “Regal Ceramics”).

Jurisdiction

2. The Commission brings this action against Mr. Muhammad Sarfraz, FCA pursuant to the provisions of Section 260 and Section 255 read with Section 476 of the Ordinance. The powers under the aforesaid provisions have been delegated to the undersigned through the S.R.O. No. 230(I)/2001 dated April 16, 2001.



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Profile of the Auditor

3. Mr. Muhammad Sarfraz is a Fellow Member of the Institute of Chartered Accountants of Pakistan (the "ICAP") and was registered with ICAP on November 25, 1985 under Registration Number 1552. He is conducting his business under the name and style of "A. Aziz Chaudhry & Co., Chartered Accountant", at 38-Shahrah-e-Quaid-I-Azam, Lahore. M/S A. Aziz Chaudhry & Co., Chartered Accountant is a sole proprietorship, therefore, Mr. Muhammad Sarfraz, FCA himself has been the auditor of Regal Ceramics for the last several years.

Background Facts

4. Mr. Muhammad Sarfraz has also conducted the audit of the annual accounts of Regal Ceramics for the year ended June 30, 2000 and signed his report on the said accounts subsequent to which, Regal Ceramics failed to prepare its annual and interim accounts and to hold its annual general meetings as required under the law. This state of affairs raised apprehension about the management of affairs of the Company. The Commission, therefore, conducted examination of the latest available financial statements of Regal Ceramics for the year ended June 30, 2000 and initiated proceedings against the directors for contravening various provisions of the Ordinance. During the course of these proceedings, it was transpired that Regal Ceramics had closed down its operations since June 05, 2000; all labour and staff had been laid off; its lenders had gone to the Courts for recovery of their outstanding loans. Despite these uncertainties pertaining to the future of the company, the auditor has given a clean bill of health to Regal Ceramics by issuing an unqualified report to the



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shareholders, investors and general public. It was, therefore, considered necessary to determine, among other matters, as to whether the Auditor's Report pertaining to the aforesaid accounts has been made in conformity with the requirements of Section 255 of the Ordinance, is otherwise true, contains no statement, which is materially false and that there is no omission of material facts about the affairs of the Company. For this purpose, a detailed examination of the accounts of Regal Ceramics was carried out. This examination assumed more importance because Regal Ceramics had collapsed soon after the close of the year ended June 30, 2000.

5. The examination of the accounts revealed that Regal Ceramics has accumulated losses to the tune of Rs. 83.966 million as at June 30, 2000 against equity comprising only of paid up capital amounting to Rs. 73 million. It was also discovered that Regal Ceramics had continuously been sustaining losses since 1994 as is evident from the following financial highlights given in its 25th Annual Report for the year ended June 30, 2000:

<i>Year</i>	<i>Loss before tax Rupees in million</i>
1994	18.444
1995	21.096
1996	17.689
1997	11.487
1998	5.733
1999	9.994
2000	3.232

Moreover, Regal Ceramics had negative equity of Rs. 10.966 million as on June 30, 2000 whereas its total long-term loans as on that date were Rs. 101.659



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million. The current liabilities exceeded its current assets by Rs. 36.037 million on the said date. The position of equity, debt, current assets and current liabilities for the years 1995 to 2000 is as follows:

	<i>2000</i>	<i>1999</i>	<i>1998</i>	<i>1997</i>	<i>1996</i>	<i>1995</i>
	<i>Rupees in Million</i>					
Paid up Capital	73.000	73.000	73.000	73.000	73.000	73.000
Accumulated Loss	(83.966)	(79.023)	(68.563)	(62.165)	(50.017)	(31.546)
Shareholder's Equity	(10.966)	(6.023)	(4.437)	10.835	22.983	41.454
Current Liabilities	76.629	79.960	72.851	99.219	102.559	81.914
Current Assets	40.592	42.797	34.938	47.219	39.694	22.503
Loss for the Year	3.232	9.995	5.733	11.487	17.689	21.096

The aforesaid financial indicators showed a net current liability position, adverse key financial ratios, substantial operating losses, discontinuance of dividend, inability to pay creditors on due dates and inability of the management to run the project profitably.

6. It was also noticed from the perusal of the aforesaid accounts that long-term loans obtained from Pakistan Industrial Credit and Investment Corporation Limited (hereinafter referred to as "PICIC") were re-scheduled in January 1998 to be repayable in 126 monthly installments commencing from January 01, 1998 and ending on December 01, 2008. Regal Ceramics, however, failed to meet its obligation towards PICIC by not making timely repayments despite re-scheduling of loans. Even mark up on PICIC loans was not serviced and an amount of Rs. 21.534 million was outstanding against the Company on this account as on June 30, 2000.



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7. It was also observed from the perusal of the directors' report to the members attached to the annual accounts under Section 236 of the Ordinance that the directors while discussing future prospects of Regal Ceramics had given a gloomy picture to the shareholders and investors. In a nutshell, the report of the directors suggested that Regal Ceramics was at the brink of collapse and insolvency. The said report of the directors clearly, unambiguously and unequivocally admitted that the ability of the company to continue as a going concern was doubtful. For ease of reference, some of the relevant contents of the directors' report are reproduced hereunder:

- The state of the Company's finances is become critical to the extent that debt servicing is totally stopped.
- PICIC and Muslim Commercial Bank Limited mark-up is piling up. PICIC and Muslim Commercial Bank Limited have issued legal notices asking for payment of their "over dues" and return of total loan amounts.
- The minus equity persists and has attracted the Prudential Regulations of State Bank of Pakistan.
- It has not been possible to utilize the production capacity beyond 40%.
- Expansion project capacity still remained closed.
- Refusal by the sponsoring directors to inject more finances has aggravated the financial state of the Company and it lagged in debt servicing.
- Due to abrupt decline in the sales during April-May 2000, it was not possible to keep the concern running and sustain huge losses.
- It was decided to carry out gradual "lay off" work force and curtail production to avoid accumulation of recurring expenses.
- The major part of the factory was, thus, closed down as of June 05, 2000.

The directors' report, thus, concluded, "the financial state of the Company has become unmanageable for further operations. Its closure is must. Induction of funds to the tune of Rs. 40 million is required to revive the Company. Some of the sponsoring directors do not agree to the induction of more funds. Issue of right shares of Rs. 27 million has not been provided for the reason. In case



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induction of funds is not agreed by the sponsoring directors, the voluntary liquidation has to be resorted.”

8. The aforesaid disclosures in the directors’ report sounded no warning to the auditor. The strong indicators i.e., closure of the factory, substantial operating losses, negative capital and reserves, current liabilities exceeding current assets, default in payment of debts, continuous losses for the past seven years, underutilization of available capacity, expansion project in doldrums, refusal of sponsors to inject further funds, substantial decline in sales, lay off of work force, inability to obtain further finances and anticipated liquidation were clear indications of a bleak future of Regal Ceramics at the time of signing of the report by the auditor. The only conclusion that could be drawn from these indicators is that Regal Ceramics would not be able to continue as going concern. The directors’ report admitted the fact that the company was no longer a going concern. The accounts of Regal Ceramics were, however, prepared on going concern basis and did not provide any information to the shareholders and investors on going concern issue. It was noted that despite the admission by the directors about inability of the company to continue as going concern, the auditor had issued an unqualified report, signed by him on November 18, 2002. It appeared that Mr. Muhammad Sarfraz neither satisfied his professional duty nor pressed the management for evidence normally required by a skeptical auditor to satisfy that whether or not going concern assumption was not subject to question.

9. It was further revealed that Regal Ceramics has sustained an after tax loss of Rs. 3.751 million during the year ended June 30, 2000, however, interim dividend @ 5% was declared and paid on the basis of half-yearly accounts for the period ended December 31, 1999, which depicted a profit of only Rs. 0.897 million. The auditor, however, has failed to report that this dividend was paid out of capital, as there were no accumulated profits/reserves and the full year’s



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results were also negative. This was also in contravention of the provisions of Section 249 of the Ordinance, which requires that no dividend shall be paid otherwise than out of profits of the company.

10. It was further noticed from the perusal of the accounts that Regal Ceramics has not observed the following requirements of the following International Accounting Standards (IAS) and Fourth Schedule to the Ordinance in regard to the accounts and preparation of the Balance Sheet and Profit and Loss Account for the year ended June 30, 2000:

- Disclosures of financial instruments as per requirements of IAS 32 (Financial Instruments: Disclosure and Presentation).
- Disclosure of Earnings per Share as per requirements of IAS 33 (Earnings Per Share).
- Disclosure of Staff retirement benefit as per Para 120 of International Accounting Standard 19 (Employee Benefits).
- Disclosure of accounting policy for borrowing costs as per IAS 23 (Borrowing Costs).
- Disclosure of repayment period of running finance as per Clause (ii)(a) of Para 12B of Part II of the 4th Schedule to the Ordinance.
- Disclosure of long-term loan as per Clause (b) of Sub-Para (E) of Para 8 of Part II of the 4th Schedule to the Ordinance.

11. Mr. Muhammad Sarfraz, the Auditor of Regal Ceramics, however, has not drawn attention of the members towards the aforesaid non-disclosures in his Audit Report signed on November 18, 2000 and instead has given a unqualified opinion stating that the balance sheet, profit and loss account together with the notes forming part thereof have been drawn up in conformity with the



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Ordinance and 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 the approved accounting standards as applicable in Pakistan and give the information required by the Ordinance in the manner so required. He has also represented to the investors and the general public that his audit was conducted in accordance with the auditing standards as applicable in Pakistan and that the accounts of Regal Ceramics gave a true and fair view of its affairs. It was, however, apprehended that contrary to his representation in his audit report, he has not conducted audit of the Company in accordance with the Auditing Standards as applicable in Pakistan.

12. In view of the above circumstances, the Commission felt concerned about the quality of audit conducted by Mr. Muhammad Sarfraz and 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 not misleading and false. *Prima facie*, this appeared to be a case where the auditor had failed to prepare a report in conformity with the requirements of Section 255 of the Ordinance and the report was otherwise untrue and contained statements, which were materially incorrect and false. This failure, *prima facie*, assumed more importance because of the collapse of the Company immediately after the close of year ended June 30, 2000 on which the auditor has issued an unqualified and clean report.

Show Cause Notice

13. Consequently, a notice dated October 30, 2002 was issued to Mr. Muhammad Sarfraz pointing out clearly his responsibility under the Ordinance, International Accounting and Auditing Standards and the *prima facie* false and



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misleading statements made by him in his report on the accounts of Regal Ceramics. He was called upon to show cause as to why action may not be taken against him for the contraventions of the mandatory provisions of law. The reply to the show cause notice was received through letter dated November 11, 2002. In order to provide an opportunity of personal hearing, the case was fixed on December 02, 2002. Mr. Muhammad Sarfraz appeared at the time of hearing and argued the case.

Submissions of Mr. Muhammad Sarfraz

14. In the written submissions as well as at the time of hearing of this case, Mr. Muhammad Sarfraz forcefully resisted that there was any uncertainty regarding the going concern assumption at the time of signing of his report. He submitted that only a portion of the factory was closed on June 05, 2000 i.e., just 25 days before the close of the financial year ended June 30, 2000. Since the factory remained in operation even after June 05, 2000, the management was not having significant doubt on the ability of the Company to continue as a going concern. Moreover, the management was making arranging funds to repay the lending agencies and subsequently some payments were also made to PICIC. He also averred that had he audited the subsequent accounts of the Company, the qualification regarding going concern as per Para 23 of the IAS 1(Presentation of Financial Statements) would have certainly been incorporated in the audit report. As regard to the payment of interim dividend, he contended that this was done out of interim profits for the period ended December 31, 1999 in compliance with the notice dated March 03, 2000 of the Commission under Section 265 of the Ordinance. He also submitted that all disclosures were made in the financial statements and there was no need to qualify the audit report. He, however, did not address the non-disclosure of information required



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by International Accounting Standards and Fourth Schedule to the Ordinance as stated in the show cause notice. His attention was drawn towards clear signals in the directors' report suggesting inability of the company to continue as going concern and a question was posed to him about the procedure carried out by him to ascertain the appropriateness of going concern assumption. He could neither provide a satisfactory answer to the said question nor was he able to produce any document to substantiate his assertion that he had conducted the audit of Regal Ceramics in accordance with the applicable Auditing Standards. He was also asked to provide audit working papers containing audit evidence gathered by him during the course of his audit; however, he could bring only a copy of the letter of representation, which appeared to be the only document he had relied for issuance of an unqualified audit report. When enquired about any evidence regarding operations of the Regal Ceramics particularly quantities produced and sold from the date of closure of the plant i.e., June 05, 2000 to November 18, 2000 i.e., date of audit report, he could produce a single document or a satisfactory reply.

Consideration of Submissions of Mr. Muhammad Sarfraz

15. Reverting to the arguments of Mr. Muhammad Sarfraz, I would first discuss the going concern issue. It was submitted that there was no question of going concern assumption being inappropriate when the audit report was signed. This argument does not carry any merit because of the simple reason that the directors' in their report had admitted that major part of the factory was closed down. Moreover, the sponsors were not willing to inject more funds needed for the survival of the company. Even otherwise, the strong indicators were existed (as noted in the preceding paragraphs) at the time of signing of his report, which clearly suggested that the going concern assumption was no



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longer appropriate. In the circumstances, it was the duty of the auditors to have carried out procedure provided by the Auditing Standard 23 (Going Concern). At this point, it is necessary to look at the requirements of Auditing Standard 23, which provides comprehensive guidelines with regard to indications of possible going concern issue and procedures to be performed to adequately address it. Its Para 2 requires that when planning and performing audit procedures and in evaluating results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. Moreover, Para 5 requires that the auditor should consider the risk that the going concern assumption may no longer be appropriate. The Standard also provides a list to exemplify the possible indications of risk regarding going concern that could be considered by the auditors. These are:

Financial Indications

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- Adverse key financial ratios.
- Substantial operating losses.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Difficulty in complying with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating Indications

- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.



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- Labor difficulties or shortages of important supplies.

Other Indications

- Non-compliance with capital or other statutory requirements.
- Pending legal proceedings against the entity that may, if successful, result in judgments that could not be met.
- Changes in legislation or government policy.

Para 8 of the Standard requires that when a question arises regarding the appropriateness of the going concern assumption, the auditor should gather sufficient appropriate audit evidence to attempt to resolve, to the auditor's satisfaction, the question regarding the entity's ability to continue in operation for the foreseeable future. Para 9 provides that when a question arises regarding going concern assumption, certain usual audit procedures may take on additional significance or it may be necessary to perform additional procedures or to update information obtained earlier. Procedures that are relevant in this connection have also been identified and are as follows:

- Analyze and discuss cash flow, profit and other relevant forecasts with management.
- Review events after period end for items affecting the entity's ability to continue as a going concern.
- Analyze and discussing the entity's latest available interim financial statements.
- Review the terms of debenture and loan agreements and determine whether any have been breached.
- Read minutes of the meetings of shareholders, the board of directors, and important committees for reference to financing difficulties.
- Inquire of the entity's lawyer regarding the existence of litigation and claims.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Consider the entity plans to deal with unfilled customer orders.



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Paras 12 to 18 of Auditing Standard 23 also provide guidance to the auditors on audit conclusion and reporting in different set of circumstances when confronted with the issue of going concern assumption. Mr. Muhammad Sarfraz has admitted that he could not ensure compliance with the requirements of Auditing Standard 23 while dealing with the going concern issue. The representation given in the audit report that he had conducted his audit in accordance with the Auditing Standards as applicable in Pakistan is, therefore, incorrect, misleading, false and untrue.

16. Mr. Muhammad Sarfraz has also contended that he had obtained representation letter from the management on the issue of going concern. This contention is not sustainable, as this is not the only audit evidence for the auditor to have relied upon in the matter. He was required to consider several other factors and also follow the procedure as stipulated by Auditing Standard 23. Mr. Muhammad Sarfraz has not followed these procedures while conducting the audit of Regal Ceramics. It is also necessary to look at the representation of the management regarding going concern issue. This is contained in Part E of the Representation Letter and being relevant to this issue, is reproduced as follows:

QUOTE

“Although a portion of the factory was closed on June 05, 2000, the factory is in operation till today. We hope that the factory will run in full production in the next month as the funds are being arranged from the sponsors.

UNQUOTE

The directors’ report to members on the accounts of the Company for the year ended June 30, 2000, however, categorically and unequivocally stated that a major part of the factory was closed down on June 05, 2000 and concluded that



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financial state of the Company was unmanageable for future operations and its closure was must. In view of the contradictory statements in the representation Letter and the directors' report, it was the duty of the auditor to have investigated the matter further. In this regard Para 9 of the AS 22 (Management Representation) provides that if other audit evidence contradicts a representation by the management, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by the management. Moreover, the representation by the management cannot be a substitute for the other audit evidence that could be available to the auditors. In this case, the directors have admitted that the company was not a going concern. Even otherwise, the indications of going concern uncertainty were quite visible. In the circumstances, there was no need to get any representation from the management. Instead, it was necessary to carry out audit procedures to ensure that the going concern assumption was not inappropriate. As working paper files were not provided to see the procedures carried out by the auditors, therefore, it can be inferred that he has not conducted his audit in accordance with the applicable Auditing Standards. He, therefore, has failed to exercise due care and skills in the performance of his duties as an auditor of a listed Company.

17. It is also important to refer to requirement of Auditing Standard 14 (Other Information) in respect to consideration by the auditor of the other information including directors' report to be included in the annual report. The relevant references of the said Standard are reproduced hereunder:

Para 9 In order that an auditor can consider other information included in the annual report, timely access to such information will be required. *The auditor*



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therefore needs to make appropriate arrangements with the entity to obtain such information prior to the date of the auditor's report.

Para 11 *If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be amended.*

Para 12 *If an amendment is necessary in the audited financial statements and the entity refuses to make the amendment; the auditor should express a qualified or adverse opinion.*

It is, thus, clear that when the information provided in the directors' report contradicts with the representation made by the directors to the auditors, it becomes the duty of the auditor to carry out further procedures to discharge his obligations and responsibilities. It is apparent that the auditor has not made assessment of the other information to be published in the Annual Report as per guidelines provided in Auditing Standard 14 (Other Information). His statement in his report that he has conducted the audit in accordance with the auditing guidelines again is false and untrue.

18. On my enquiry as to what audit steps he has followed to review subsequent events; he was not able to give any satisfactory reply or draw a list of any audit procedures followed in this regard. For ease of reference, the said requirement of Auditing Standard 21 (Subsequent Events) is, to the extent relevant, reproduced as follows:

Para 4 *“the auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. These procedures are in addition to routine procedures, which may be applied to specific transactions occurring after period end to obtain audit evidence as to account balances as at period end, for example, the testing of inventory cutoff and payments to creditors. The auditor is not, however, expected to*



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conduct a continuing review of all matters to which previously applied procedures have provided satisfactory conclusions.”

Para 5 *“the procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor’s report and ordinarily include the following:*

- *Inquiring of management as to whether any subsequent events have occurred which might affect the financial statements. Example of inquiries of management on specific matter include:
 - *Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, is such events call into question **the validity of the going concern assumptions.****

19. It has also been noted that International Accounting Standard 1 (Presentation of Financial Statements) requires that the management to make assessment of the ability of the entity’s to continue as going concern. The relevant requirements of the said IAS are reproduced as under:

Para 23 When preparing financial statements, management should make an assessment of an enterprise’s ability to continue as a going concern. Financial statements should be prepared on a going concern basis unless management either intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the enterprise’s ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason why the enterprise is not considered to be a going concern.

Para 24 In assessing whether the going concern assumption is appropriate, management take into account all available information for the foreseeable future, which should be 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



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profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be 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 itself that the going concern basis is appropriate.

In this case, it appears that the management had made an assessment that is why, the directors in their report to the shareholders had categorically stated that the closure of the factory was a certainty. The accounts, however, failed to portray the uncertainties surrounding the company's ability to continue as going concern. In the circumstances, it was the duty of the auditors to have brought this fact and violation of International Accounting Standard to the knowledge of the shareholders in his report. In this respect the following guidance contained in Para 17 of Auditing Standard 23 (Going Concern), is also most relevant:

QUOTE

if adequate disclosure is not made in the financial statements, the auditor should express a qualified opinion or adverse opinion, as appropriate.

UNQUOTE

The auditor has miserably failed in his duty to safeguard the interest of those who have appointed them by not reporting the true position of the state of affairs and making false and incorrect representation to them.

20. The entity's continuance as a going concern for the period exceeding one year is assumed in the preparation of financial statements. In this case the Company has collapsed soon after the close of the financial year on which the auditor has given his clean report. There were several indicators, which have already been discussed in the foregoing paras of this order that could have



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aroused suspicion about the appropriateness of going concern assumption. The auditor, therefore, has failed in his responsibility to perform his duties with reasonable care and skills.

21. Having heard Mr. Muhammad Sarfraz and after examination of the relevant provisions of law, I am of the opinion that the arguments advanced by him are totally unsatisfactory and deficient. The explanations given by him for not modifying the audit report on going concern issue are not justifiable. The other arguments advanced by Mr. Muhammad Sarfraz that the sales for the year 2000 were more than preceding year and the directors in their report to members have disclosed fullest information to the shareholders do not in any way relieve the auditors of their responsibilities from complying with the mandatory requirements of the Ordinance and Auditing Standards.

22. The contentions that Regal Ceramics declared dividend on the instructions of the Commission is also baseless as the Company can only declare dividend out of profit of a Company as provided in Section 249 of the Ordinance and the Commission cannot direct any company to pay dividend not having any profit. The Commission, however, expects that the Company should give a reasonable return to the shareholders without violating the provision of law. The argument that all the necessary disclosures have been made is not sustainable, as he has not given specific response to the various disclosures deficiencies.



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Role and Responsibilities of Auditors

23. 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. Practically, it is the management of companies, which by virtue of their majority power hire and fire the auditors. In these circumstances, the auditors often violate the mandatory provisions to accommodate their clients with a favorable report to ensure continuity of their appointment. There is a need that the auditors must realize their true role and restrain themselves from performing their duties indulgently.

24. 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



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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 he fails to make out a report in accordance with the legal requirements. When persons other than those who manage the company contribute the money, there is an inherent risk that the affairs could not be managed in the best interest of the shareholders. It becomes so in the case where the interest of the directors, who themselves are the shareholders is in conflict with the interest of other shareholders. In such a case it becomes more important for the auditors to be vigilant and perform their duties and obligation with extreme care while auditing the accounts and books of accounts.

25. In the case in hand, there is a total failure in meeting the expectation of the investors and public at large by the auditor. Such gross negligence by the auditors while considering appropriateness of the going concern assumption could shake the confidence of the stakeholders. This could also have adverse impact on the investment climate and economy of the country. Moreover, image of the frontline regulators and accounting profession would be seriously



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undermined by such gross negligence and one has to learn lesson from Enron and Arthur Anderson episode.

Conclusion

26. It is clear from the above discussion that the auditor has failed to perform his statutory obligations by not giving fullest information to the members. It was incumbent on the Auditor to have drawn attention to the members of Regal Ceramics towards the non-compliances/ contraventions in his Audit Report to the members. In the circumstances, it is clear that the Auditor has failed to perform his professional duties with reasonable degree of care and skill. He knowingly and recklessly ignored his observations and gave a clean bill of health on the Regal Ceramics accounts. He has not put to risk his association with the management of Regal Ceramics from where he was getting good money annually in the form of audit fee instead of acting as a watchdog on behalf of the shareholders.

27. Mr. A. Aziz Chaudhry falsely represented to the public, the investors and the regulatory authorities that the audit was conducted in accordance with the applicable auditing standards and that the financial statements presented a true and fair view. The investors and the general public expect from the auditors unfailing commitment and dedication to the principles of accountancy. The failure of the auditor in this case is a serious event and practicing chartered accountants must ensure that such events should not be repeated.



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Order

28. In view of the forgoing, the lapses, irregularities, non-compliances and deliberate acts on the part of the auditors to conceal and suppress the information from the shareholders of the Company 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 Sarfraz during the course of hearing of this case. Now it remains to be considered as to what order should be passed against Mr. Muhammad Sarfraz, FCA. These proceedings were initiated under Section 260 and 492 of the Ordinance. Section 260 has two sub-sections, which deals with the punishment of the auditors for non-compliance with the mandatory provisions. Sub-section (1) provides that if any auditor's report is made otherwise than in conformity with the requirements of Section 255 or is otherwise untrue or fails to bring out material facts about the affairs of the company or matters to which purports to relate, the auditors concerned and the person other than the auditors who signs the report 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 two thousand rupees. This fine has since been enhanced to one hundred thousand rupees through an amendment brought about by the Companies (Amendment) Ordinance, 2002 promulgated on October 26, 2002. However, as the default pertains to the report made out by Mr. Muhammad Sarfraz, before the date of this amendment, therefore, the revised penalty is not applicable in his case. I, therefore, impose a fine of Rs 2,000 for making default under Sub-section (1) of Section 260 of the Ordinance.



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29. The deliberate acts of Mr. Muhammad Sarfraz are positive disservice to shareholders, creditors and public at large. If such violations go unnoticed the confidence of the investors would be shaken, which in turn would be disastrous for the economy of the country. The nature of concealment of material facts in the present case from the shareholders and non-disclosure of information by the management in the annual accounts for the year ended June 30, 2000 to the shareholders are serious violations and could perhaps also attract the provisions of Sub-section (2) of Section 260 of the Ordinance. However, I am referring the matter to ICAP for appropriate action under the Chartered Accountants Ordinance, 1961.

30. Mr. Muhammad Sarfraz 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.

31. Before parting with this Order, I would like to make an observation. The name of M/S A. Aziz Chaudhry & Co., is included in the list of firms who have been given satisfactory quality control rating by ICAP. The information gathered by the Enforcement and Monitoring Division of the Commission indicates that M/S A. Aziz Chaudhry had no other audit of listed companies except Regal Ceramics and that too was conducted for the year ended June 30, 2000. As is amply clear from this Order that Mr. Muhammad Sarfraz has been grossly negligent in the performance of his duties in respect of audit of the Company, it is surprising that his Quality Control Review was found to be satisfactory by ICAP. ICAP, therefore, may like to look into the files pertaining to quality control review in respect of Mr. Muhammad Sarfraz. A copy of the Order may be sent to President, ICAP for his information and necessary action



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in accordance with the provisions of the Chartered Accountants Ordinance,
1961.

RASHID SADIQ
Executive Director (Enforcement & Monitoring)

Announced
April 29, 2003
ISLAMABAD