



SECURITIES & EXCHANGE COMMISSION OF PAKISTAN
SPECIALISED COMPANIES DIVISION

Before Sadia Khan, Executive Director

IN THE MATTER OF

M/S. FORD, RHODES, ROBSON, MORROW,

STATUTORY AUDITORS OF

PAKISTAN INDUSTRIAL & COMMERCIAL LEASING LIMITED

Date of hearing:

April 17, 2002

Present:

Mr. Salim Chinoy, Mr. Syed Tariq Jamil and
Mr. Mehmood Mandviwalla for and on
behalf of Ford, Rhodes, Robson, Morrow,
Chartered Accountants

Ms. Irum Butt, Director, Ms. Jaweria Ather,
Joint Director and Mr. Asif Bhatti, Deputy
Director



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ORDER

This order has been made pursuant to a show cause notice under section 255 read with section 260 of the Companies Ordinance, 1984, served by this office on M/S Ford, Rhodes, Robson, Morrow, Chartered Accountants on January 16, 2002. Brief facts that gave rise to the said show cause notice are as under:

1. M/S Ford, Rhodes, Robson, Morrow, Chartered Accountants (hereinafter referred to as FRRM), having its head office at Finlay House, I.I. Chundrigar Road, Karachi, was appointed by M/S Pakistan Industrial & Commercial Leasing Limited (hereinafter referred to as the "Company"), being a public listed company limited by shares and having its registered office at 504, Park Avenue, 24-A, Block 6, P.E.C.H.S., Karachi, as its statutory auditors under section 252 of the Companies Ordinance, 1984 (hereinafter referred to as the "Ordinance"). FRRM has been the statutory auditors of the Company since its incorporation in 1987.
2. The Securities and Exchange Commission of Pakistan (hereinafter referred to as the "Commission") appointed a special auditor, M/S Ibrahim, Shaikh & Co., Chartered Accountants, under rule 19 of the Leasing Companies (Establishment and Regulation) Rules, 2000 to conduct a special audit of the Company for the year ended June 30, 2000. The special auditor, *inter alia*, reported that an amount of Rs. 37.092 million has been siphoned out of the Company through fake leases to M/S Alpine International (Pvt.) Limited (hereinafter referred to as "AIL") and M/S Mehran Animal & Poultry Feeds (Pvt.) Limited (hereinafter referred to as "MAPFL"). Further details were given as follows:



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- (a) in June 1999, the management of the Company sanctioned two leases, under sale and lease back arrangement, amounting to Rs. 46.82 million and Rs. 15 million, to AIL and MAPFL respectively for purchase of flour mill machinery;
 - (b) in July 1999, lease money of Rs. 28.092 million and Rs. 9 million was disbursed to AIL and MAPFL respectively under sale and lease back agreements without the existence of flour mill machinery;
 - (c) AIL and MAPFL paid one lease instalment each of Rs. 1.474 million and Rs. 0.339 million respectively during the year ended June 30, 2000 before rescheduling of the leases was requested; and
 - (d) the lease transactions with AIL and MAPFL were not genuine since there were no underlying assets when money was disbursed by the Company to AIL and MAPFL and no document was available on record that could prove existence/ ownership of the assets, like a survey report or insurance documents, which are considered essential in a sale and lease back arrangement.
3. On the basis of the special audit report, I inquired from FRRM, vide letter dated August 6, 2001, as to why no apprehension regarding fake leases, given by the Company to AIL and MAPFL, was reported in the auditors' report for the year ended June 30, 2000, despite the materiality of the amounts involved. As on June 30, 2000, the principal amount of the leases in question was recorded at Rs. 47.228 million in the books of account of the Company. On the same date, the amount of mark-up taken to income against these leases was Rs. 2.104 million. Since leases with AIL and



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- MAPFL had been identified as fake in the special audit report, these amounts should have been fully provided for. However, no provision was made in the accounts of the Company for the year ended June 30, 2000 and the same was not considered by FRRM in forming its opinion on the financial statements of the Company.
4. FRRM, through its letter dated August 31, 2001, replied that lease facilities to AIL and MAPFL did not appear to be fictitious on the basis of documentation and representations provided by the management during the course of the statutory audit. It was further explained that, in the case of lease facility given to AIL, invoice of Rs. 46.820 million for flour mill machinery was on record and the asset was insured by Adamjee Insurance Company. The lack of provision in the books of account of the Company was justified on the basis that leases with AIL and MAPFL were rescheduled in April 2000 and June 2000 respectively and the number of days of default was, therefore, less than the minimum prescribed number of 180 days. Moreover, payments were received by the Company from AIL and MAPFL subsequent to the year end. In its explanation, FRRM also referred to the valuation of leased assets performed by M/S Razzaq Umerani & Co. (Pvt.) Limited (hereinafter referred to as "Razzaq Umerani & Co.") on November 27, 2000, which showed the value of assets at Rs. 46.50 million and Rs. 15 million, respectively.
 5. Since Razzaq Umerani & Co. had provided valuation of assets, which were the subject of fake sale and lease back arrangements between the Company and AIL and MAPFL, an explanation was demanded from Razzaq Umerani & Co. A reply, dated December 8, 2001, was furnished to my office and it was explained that valuation was provided after proper inspection of machinery, which was lying at warehouse of the supplier, in one case, and at the port, in the other case. Razzaq Umerani & Co. further pointed out that a representative of the external auditors of the Company (i.e.



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FRRM) had also inspected the machinery before its valuation by Razzaq Umerani & Co. Documentary evidence of import, including copies of invoices, packing lists and bills of lading, were also provided. On further inquiry, Razzaq Umerani & Co. confirmed that the machinery, at the time of its valuation on November 27, 2000, was owned by the supplier M/S Johar Associates.

6. Upon a critical examination of the information provided by FRRM and Razzaq Umerani & Co., along with the observations made in the special audit report, it appeared that FRRM, being the statutory auditors of the Company, failed to bring out material facts about the affairs of the Company in the auditors' report for the year ended June 30, 2000. In arriving at its opinion on the financial statements of the Company for the year then ended, FRRM appeared to have failed to detect or obtain reasonable assurance about the peculiar circumstances of lease transactions with AIL and MAPFL, including the following:
 - (a) the sale and lease back arrangements with AIL and MAPFL were made on June 25, 1999 and December 10, 1998 respectively. The machinery, which was the subject of these sale and lease back agreements, was neither available with nor owned by any of the parties involved, i.e. AIL, MAPFL and the Company, at the time of entering into the arrangement;
 - (b) amounts of Rs. 28.092 million and Rs. 9 million were disbursed by the Company to AIL and MAPFL, respectively, in June 1999. No payment was made by the Company to the supplier for acquisition of machinery; rather the entire lease money was paid directly to AIL and MAPFL;



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- (c) the legal title or physical possession of the machinery had not been transferred to either the Company, AIL or MAPFL by June 30, 2000. Till the time the audit for the year ended June 30, 2000 was concluded, the machinery was lying at port, in the case of AIL, and at the supplier's warehouse, in the case of MAPFL. The ownership of the machinery was also with the supplier; and
- (d) no provision against leases with AIL and MAPFL was made in the books of account of the Company.
7. In this regard, I considered the duty of statutory auditors as established by the Ordinance. The sub-section (3) of section 255 of the Ordinance requires auditors to state in the auditors' report that proper books of account have been kept by the company, financial statements have been drawn up in conformity with the Ordinance and are in agreement with the books of account and these financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and of the profit or loss for such year. The sub-section (3) of section 255 of the Ordinance also requires auditors to give their opinion in the auditors' report that the expenditure incurred during the financial year was for the purpose of the company's business and the business conducted, investments made and expenditure incurred were in accordance with the objects of the company. The sub-section (1) of Section 260 of the Ordinance requires a fine to be imposed on auditors in case auditors' report on financial statements for any year is untrue or fails to bring out material facts about the affairs of the company, in contravention of the provisions of section 255 of the Ordinance. The sub-section (2) of section 260 provides additional penalty by way of a fine and imprisonment in case auditors' report, which has been held under sub-section (1) to be in contravention with the requirements of section 255, is made with the



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intent to profit the auditor or any other person or to put another person at a disadvantage or loss or for a material consideration.

8. On the basis of the above, a notice was issued to FRRM by this office on January 16, 2002 to show cause in writing as well as to be heard in person or through an authorized representative so as to explain why a penalty may not be imposed under section 260 of the Ordinance. FRRM submitted its explanations vide its letters dated January 28, March 8, April 22 and April 29, 2002. Duly authorized representatives of FRRM also appeared before me for a hearing on April 17, 2002. I would now like to examine the explanations furnished by FRRM.

- (a) FRRM has asserted that adequate documentation in support of lease transactions with AIL and MAPFL was available with the Company at the time of statutory audit. These documents included invoices, packing lists, correspondence with AIL and MAPFL, sale and lease agreements, details of payments received from AIL and MAPFL, surveyor's report and insurance cover note. The documents were examined by FRRM during the course of audit of financial statements for the year ended June 30, 2000. Through a later correspondence on April 22, 2002, FRRM has, however, mentioned that there was no insurance cover as on June 30, 2000 since the machinery was not insurable under the conditions of insurance cover as it had not been installed at the premises of either AIL or MAPFL. The absence of insurance cover was highlighted by FRRM to the Board of Directors vide its letter dated December 2, 2000.

In this regard, I have considered the ability of FRRM to obtain sufficient and appropriate audit evidence and to use that evidence to draw reasonable



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conclusions on which the audit opinion was based. This responsibility has been placed on auditors under the International Standard on Auditing (ISA) 8. While FRRM was able to obtain and examine sufficient documentary evidence underlying the lease transactions, it failed to determine whether such evidence was appropriate or not to support financial statement assertions with respect to “existence” (i.e. an asset or a liability exists at a given date) and “rights and obligations” (i.e. an asset or a liability pertains to the entity at a given date). I would now discuss below the basis of my conclusion that FRRM failed to obtain reasonable assurance during the statutory audit for the year ended June 30, 2000 that lease facilities given to AIL and MAPFL genuinely existed and the underlying assets were owned by the Company at the balance sheet date.

FRRM examined sale and lease agreements of AIL and MAPFL. However, it failed to take into cognizance the fact that no machinery existed at the time these agreements were made. A sale and lease back agreement is, in substance, a loan given to the lessee on the security of assets. In the case of AIL and MAPFL, the Company disbursed the loan without the security of assets. It is, therefore, apparent that the lease transactions were entered into to obtain funds from the Company without adequate security backing. This conclusion is further reinforced by the arrangement whereby lease money was not disbursed to the supplier but was paid directly to AIL and MAPFL. In a situation where the asset did not physically exist at the time of sale and lease agreements and no payment was made by the Company to the supplier, it seems odd that FRRM relied only on the fact that sale and lease agreements were



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executed and were available for its inspection but failed to consider the nature of arrangements made between the Company and AIL and MAPFL.

Further, FRRM also examined suppliers' invoices for the machinery. I am of the view that those invoices were not appropriate evidence to support ownership of assets by the Company. The invoices indicated that delivery of assets to AIL and MAPFL would be made during November/ December 2000. Further, FRRM was also aware that the assets had not been imported by AIL and MAPFL by the balance sheet date. In such a case where physical possession of assets had not been transferred, it was essential for FRRM to substantiate transfer of legal title and not rely only on examination of available documents. In fact, FRRM was given the opportunity during the course of hearing to explain as to how ownership of assets in the name of the Company, as on June 30, 2000, was verified. However, no satisfactory response was provided.

I am, therefore, of the view that FRRM relied only on examination of underlying documents, provided by the Company, but failed to corroborate the evidence through other audit procedures. As a result, an unqualified audit report was issued despite material misstatements in the financial statements.

- (b) FRRM has also debated that if leases with AIL and MAPFL were considered fictitious, it meant that evidence on record was also fictitious and third parties were involved to intentionally conceal the transactions. However, there was no indication that documentary evidence provided to FRRM was not genuine.



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I do not consider the documents on record as fictitious, to the extent that they were made out between the parties concerned. I accept that sale and lease agreements were made between the Company and AIL and MAPFL but these agreements were not executed as a genuine sale and lease back arrangement owing to non-existence of underlying assets. Similarly, other documents like invoices and packing lists were available with the Company. These documents showed that the supplier had invoiced AIL and MAPFL for advance money in respect of machinery to be imported. These documents, however, did not provide evidence as to whether or not ownership of machinery had been transferred in the name of the Company by June 30, 2000. In addition, the insurance documents reviewed by FRRM and also provided to us, vide its letter dated April 22, 2002, indicated that Admajee Insurance Company Limited had refused to extend insurance cover to the assets in question until they reach the premises of the lessees. This shows that the assets were uninsured by the time the audit for the year ended June 30, 2000 was concluded and the insurance documents were not, therefore, appropriate evidence for the purpose of the audit. In respect of valuation of machinery, performed by Razzaq Umerani & Co., valuation reports were examined by FRRM. However, these valuation reports only confirmed value of the machinery but were not appropriate evidence as to the ownership of the machinery.

As explained above, FRRM was required to apply other audit procedures in addition to examination of documents. The fact that documents were available for inspection does not justify lack of other reasonable procedures, such as obtaining direct confirmation from the supplier regarding ownership of machinery. Audit evidence is obtained from an



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appropriate mix of audit procedures and the auditors often need to seek audit evidence from different sources or of different nature to support the same assertion. I found this reasonable mix of procedures lacking in the audit conducted for the year ended June 30, 2000 due to excessive reliance placed by FRRM on examination of documents provided by the management.

- (c) Documentary evidence was provided by FRRM to this office to substantiate that it had brought certain procedural delays in the leases, under consideration, to the notice of the Board of Directors of the Company. This was done vide FRRM's letter to the Board of Directors, dated December 2, 2000. A copy of minutes of Board meeting has also been furnished to show that the then Chief Executive of the Company had given confirmation in respect of existence, valuation, repayments and conformance with the terms of leases by AIL and MAPFL. The Chief Executive was also instructed by the directors to regularize the matters. Since the matter was discussed and addressed at the highest level within the Company (i.e. in the meeting of the Board of Directors), it provided reasonable assurance to FRRM about genuineness of the transactions. FRRM also stated in its explanation to this office that at the time of audit, there was no indication that leases entered into by the Company with AIL and MAPFL were fictitious. The opinion on the financial statements of the Company for the year ended June 30, 2000 was given in the light of information and explanation furnished to FRRM.

I have examined FRRM's letter to the Board of Directors, dated December 2, 2000. FRRM had observed that sale and lease back transactions with



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AIL and MAPFL were entered into without the physical existence of leased assets as the same were imported after the amount was disbursed by the Company to AIL and MAPFL. It was also observed that the machinery had not been installed at the premises of lessees by June 30, 2000. While FRRM had rightly identified these irregularities, it was its statutory duty to report the same to the shareholders of the Company and not to the management. I consider it a major lapse on part of FRRM since it is the duty of auditors under section 255 of the Ordinance to bring out material facts about the affairs of the company and give their opinion on whether or not financial statements are fairly presented in the auditors' report to the shareholders.

FRRM has asserted that the observations made in its letter of December 2, 2000 were satisfactorily addressed by the management and the opinion of FRRM on financial statements of the Company was given in the light of information and explanations furnished by the management. I appreciate that management makes many representations to the auditor during the course of the audit. Where the representations relate to matters that are material to the financial statements, the auditors are required under ISA 22 to seek corroborative audit evidence and evaluate whether or not the representations appear reasonable and consistent with other audit evidence obtained. ISA 22 has explicitly specified that management representations cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. Consequently, the justification given by FRRM that it relied on management representations is not acceptable. FRRM was required to carry out audit procedures designed to provide



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reasonable assurance about the lease transactions with AIL and MAPFL instead of relying on representations by the management in this respect.

FRRM was asked to produce documentary evidence in respect of explanations furnished by management in response to its letter dated December 2, 2000. However, it was submitted that reliance was placed on verbal communication with the management. It is pertinent to consider that the issues raised by auditors were discussed in the meeting of the Board of Directors held on December 4, 2000. The minutes of this meeting were not finalized until December 21, 2000 when the minutes were rectified at the insistence of a director of the Company. While there was no documentary evidence available with FRRM that the observations highlighted by it were discussed by the directors, the audit report was signed by FRRM on December 5, 2000. This shows that FRRM relied on verbal representations of the management in arriving at its conclusion on lease transactions with AIL and MAPFL. These lease transactions were material enough for FRRM to obtain written representations from the management, as required by IAS 22.

When FRRM was inquired about the reason for relying on verbal communication, it was told that this is considered to be a 'normal' audit procedure in continuing audit engagements since management representations are known to be reliable. I would like to strongly condemn this practice. The auditors are appointed by the shareholders of the company and have a statutory duty towards them. In discharging this duty, the auditors should be, and appear to be, independent and must not have a cozy relationship with the management that might impair their



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independence. It is essential for auditors to preserve their integrity and objectivity while conducting audit of financial statements if the credibility of financial reporting system is to be maintained. It was in relation to such cases that the Commission recently decreed various measures, such as rotation of auditors and separation of audit and consultancy assignments, to maintain independence of external auditors.

I consider that reliance placed by FRRM on management representations coupled with its failure to obtain written representations before issuing the audit report does not reflect well on the professionalism of FRRM in this regard.

- (d) FRRM further submitted that lease instalments were received from AIL and MAPFL as per the agreed schedule. Hence, no provision was required in the books of account of the Company against these leases. It reiterated the earlier explanation that the number of days of default by AIL and MAPFL was less than the minimum prescribed number of 180 days and no provision was, therefore, necessary. Further, reference was made by FRRM to subsequent payments of Rs. 4.949 million and Rs. 0.850 million received by the Company from AIL and MAPFL respectively on two separate dates, December 15, 2000 and March 13, 2001. Documents in support of this reference (including copies of bank deposit slips) were provided to show that payments were actually received by the Company on account of leases with AIL and MAPFL.

I have considered the explanations provided by FRRM. While I accept that the criteria to determine the need for provision, as referred to by FRRM, is



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applied to leases in usual circumstances, I am of the view that the same could not have been applied in the cases of AIL and MAPFL since the leases were not considered to be genuine. Adequate provision in the books of account of the Company was, therefore, necessary against the principal outstanding in respect of fake leases with AIL and MAPFL, amounting to Rs. 35.566 million and Rs. 11.662 million respectively. Similarly, mark-up of Rs. 2.104 million, recorded in respect of these leases, needed to be reversed. Since FRRM was not able to identify lease transactions with AIL and MAPFL as fake during the audit for the year ended June 30, 2000, it also failed to recognize the need for provision against these leases.

It is evident that lease instalments were not received on time during the year ended June 30, 2000. As identified by FRRM in the letter dated August 31, 2001, both AIL and MAPFL defaulted in payment of lease rentals after the first instalment and the leases with AIL and MAPFL were rescheduled in April 2000 and June 2000 respectively. Further lease instalments were received by the Company on December 15, 2000 and March 2001 respectively. I would like to point out that audit report for the year ended June 30, 2000 was signed by FRRM on December 5, 2000. It was, therefore, not possible for FRRM to consider subsequent payments by AIL and MAPFL in obtaining reasonable assurance that the leases were regular. I am, therefore, of the view that FRRM did not consider sufficient and appropriate audit evidence to determine need for provision in the books of account of the Company against leases with AIL and MAPFL.

- (e) FRRM also submitted that Razzaq Umerani & Co. did not indicate at the time of valuation that the machinery was in fact owned by the supplier and



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not by AIL or MAPFL. In the valuation reports of Razzaq Umerani & Co., dated November 27, 2000, it was stated that the Company was the lessor and the valuation was conducted on the request of the Chief Executive of the Company while the lessees were AIL and MAPFL. It was further submitted that Razzaq Umerani & Co. qualify the valuation report in case ownership of the asset being valued is not verified. However, this was not done in the case of machinery valued on the behest of the Company and it was not indicated in the valuation report that assets were not owned by the Company or AIL or MAPFL. A copy of a qualified valuation report, issued by Razzaq Umerani & Co., was also provided to this office by FRRM in support of this contention.

I accept the explanation provided by FRRM that the valuation report of Razzaq Umerani & Co. was not qualified to reflect that machinery was not owned by the Company although the valuation report issued by Razzaq Umerani & Co. in another case was qualified on ownership of assets. However, I would like to consider the role of a valuer. A valuer is engaged to provide a reasonable estimate of the value of the asset at a particular point in time. He can be held responsible if he fails to place a reasonable estimate on the asset. However, it is not his specific responsibility to certify the ownership of the asset as well. While Razzaq Umerani & Co. did not correctly reflect ownership of machinery in valuation reports issued on November 27, 2000, FRRM could not solely rely on these unqualified valuation reports in drawing a conclusion on ownership of assets.



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As indicated in FRRM's letter dated April 22, 2002, a representative of FRRM also inspected the machinery in question on November 25, 2000. The machinery, in the case of AIL, was lying at port while the premises of the supplier were visited in the case of MAPFL. Since physical inspection was performed by FRRM as well, there was a reasonable opportunity to determine ownership of assets. In any case, FRRM could have obtained a direct confirmation from the supplier regarding the ownership of assets. I am of the view that FRRM failed to perform this necessary audit procedure and instead relied excessively on documents provided by the Company.

- (f) FRRM explained that the Company had initiated recovery proceedings against AIL in the High Court of Sindh at Karachi. The suit has been decreed in favour of the Company. A copy of the order passed by the High Court was provided to this office. It was submitted that since the High Court had passed the decree on the basis of same documentation on which FRRM had relied during the course of its audit, it proved that lease with AIL was not fictitious and leased assets existed and were owned by the Company.

I have reviewed the judgment passed by the honorable High Court. While the suit filed by PICL has been decreed in the sum of Rs. 81.75 million, it is important to consider that this judgment has been made to recover outstanding sums from AIL and does not ratify the lease transactions conducted during the year ended June 30, 2000. It has earlier been explained that the amount of Rs. 28.092 million was disbursed by the Company to AIL. However, this amount was unsecured as the underlying



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assets did not exist at the time of disbursement. The situation was unchanged as far as ownership of assets was concerned at the balance sheet date. As such, award of a decree in favour of the Company does not mean that the lease transaction with AIL was regular during the period under review. In fact, subsequent developments cannot justify lack of audit procedures followed by statutory auditors, prior to finalization of their report to the shareholders. Since FRRM had issued an unqualified report for the year ended June 30, 2000, its failure to report material misstatements in the financial statements of the Company is not rectified by a decree passed for recovery of outstanding sums from AIL.

9. Based on the above, I conclude that the explanations provided by FRRM are not satisfactory and its willful default in failing to carry out its duties as required under section 255 of the Ordinance, being the statutory auditors of the Company for the year ended June 30, 2000, is hereby established.

10. In light of the above, I, hereby, exercise the powers conferred under sub-section (1) of section 260 of the Ordinance and impose a fine of rupees two thousand for the default mentioned in para 9 above on each of the partners of FRRM, as mentioned below:
 1. Mr. Ahmed D. Patel
 2. Mr. Salim Chinoy
 3. Mr. Mustafa Khandwala
 4. Mr. Majid Khandwala
 5. Mr. Pervez Muslim
 6. Mr. Aqueel E. Merchant
 7. Mr. Asim Siddiqui



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8. Mr. Ijaz Ahmad
9. Mr. Muhammad Junaid
10. Mr. Syed Tariq Jamil

The amount of fine shall be deposited in the head of account of the Commission maintained with the designated branches of Habib Bank Limited within thirty days of the date of issue of this Order.

11. Issued under my hand and seal this 27th day of May, 2002.

(Sadia Khan)
Executive Director