



[Islamabad]

Before Rashid Sadiq, Executive Director

Order

In the Matter of

M/S Rao & Company; Chartered Accountants

Number and date of notice	EMD/Co./233/EA/634/2002 Dated November 28 2002
Date of hearing	May 20, 2003
Present	Mr. Shafqat Raza, ACA
Date of Order	June 24, 2003

This Order shall dispose of the show cause proceedings initiated under Section 260 of the Companies Ordinance, 1984 (hereinafter referred to as the “Ordinance”) against M/s Rao & Company, Chartered Accountants (hereinafter referred to as “Rao & Co.”) for making report to the members of M/s Prudential Discount and Guarantee House 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. Rao & Co., is a partnership firm and the partnership comprises of Mir Muhammad Razvi, FCA, Mr. Shafqat Raza, ACA and Mr. Nisar Ahmed, FCA. All these partners are practicing members of the Institute of Chartered Accountants of Pakistan (the “ICAP”) and were registered with ICAP on 20



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March 1962, 10 September 1998 and 14 February 1985 under Registration Numbers 188, 2852, 1479 respectively. The firm is conducting its business at 4, Karachi Chambers, Hasrat Mohani Road, Karachi – 2.

3. In order to fully appreciate the issues involved in this case, it is necessary to go into the relevant background facts of this case. Rao & Co. have audited the accounts and books of accounts of the Company and have made audit reports on the financial statements of the Company for the year ended June 30, 2001 and 2002. These reports were signed on August 9, 2002 and September 27, 2002, respectively.

4. The Enforcement and Monitoring Division conducted an examination of the financial statements of the Company for the years ended June 30, 2001 and 2002 (the “Accounts”) and it appeared that the going concern assumption used in the preparation of the financial statements was not appropriate due to the following circumstances:

- (i) A petition was filed by the Commission for winding up of the Company in the Honorable Lahore High Court, Rawalpindi Bench on August 02, 2002. A show cause notice in this regard was issued to the Company on May 08, 2002 under Sub-section 309 read with section 305 of the Ordinance and Order for filing winding up petition was passed by the Executive Director on June 17, 2002. The Honorable Lahore High Court appointed Official Liquidator on November 20, 2002 for winding up of the Company.
- (ii) The entire earning assets of the Company amounting to Rs. 133.548 million comprised of the negotiable instruments purchased/discounted, which were either overdue or under litigation.
- (iii) During the year ended June 30, 2001, the total revenue of the Company was Rs. 20.775 million out of which Rs. 19.848 million was recognized as income on the over due negotiable instruments, contrary to the requirements of the Prudential Regulations of SBP. During the year ended June 30, 2002, the total revenue of the Company was only Rs. 1.571 million.



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5. It was also noticed that the amount of Rs. 19.848 million recognized as mark-up income during the year ended June 30, 2001 was in respect of overdue negotiable instruments purchased/discounted. This was in clear contravention of the requirements of Para 1 Prudential Regulations VIII (Classification and Provisioning of Assets) of the State Bank of Pakistan, which required that where mark up/interest or principal was overdue by 90 or more days from the due date, unrealized mark up/interest be credited to suspense account and not to be credited to income *except when realized*. The recognition of mark up on overdue instruments had distorted the true and fair view of the state of the Company's affairs. Had this income not been recognized the loss for the year ended June 30, 2001 would have been higher by Rs. 19.848 million. The auditors, however, had reported that the balance sheet and profit and loss account gave the true and fair view of the state of the Company's affairs and of the loss for the year ended June 30, 2001.

6. It was also observed from the perusal of the Accounts for the year ended June 30, 2002 that the following disclosure requirements of the International Accounting Standards (IAS) and the Fourth Schedule to the Ordinance were not followed in regard to the Accounts and the preparation of the balance sheet and profit and loss account of the Company for the year ended June 30, 2002:

- Disclosure of Staff Retirement Benefits as per requirement of IAS-19 (Employee Benefits).
- Disclosure regarding rate of mark-up on Running Finance Facility as per requirement of Clause (ii)(a) of Para 12B of Part II of the 4th Schedule to the Ordinance.
- Disclosure regarding penalties imposed as per requirement of Para 4 of Part 1 of the 4th Schedule of the Ordinance.



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7. In view of the aforesaid material deficiencies and irregularities, the auditor's reports on the financial statements of the Company for the year ended June 30, 2001 and 2002 were examined to determine, as to whether these had been drawn up in conformity with the requirements of Section 255, were otherwise true, contained no statement which was materially false and that there was no omission of material facts about the affairs of the Company. It was noticed that the auditors of the Company namely, Rao & Co., had neither drawn attention of the members towards the going concern assumption being inappropriate nor had they pointed out the violations of the disclosure requirements in their report to the members on the accounts of the Company for the year ended June 30 2002. Furthermore, the audit report on the accounts for the year ended June 30, 2001 also did not contain any observation with regards to the recognition of income in contravention with the Prudential Regulations of the SBP. Instead, in the aforesaid audit reports, the auditors had stated that the balance sheet, profit and loss account together with the notes thereon have been drawn up in conformity with the Ordinance and that the balance sheet, profit and loss account and cash flow statement and notes forming part thereof conformed to the approved accounting standards as applicable in Pakistan and gave a true and fair view of the state of affairs of the Company.

8. In view of the above circumstances, the Enforcement Monitoring Division felt concerned about the quality of the audit conducted by Rao & Co. and the audit reports made by them on the accounts for the year ended June 30, 2001 and 2002. This necessitated further examination to bring to light as to whether or not the representations and statements made by the auditors to the shareholders, investors and general public were misleading and false.



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9. Consequently, a notice dated November 28, 2002 was issued to all the partners of M/s Rao & Co. 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 reports 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. In response to the show cause notice, Mr. Shafqat Raza, ACA sought extension in time for submission of reply by fifteen days. The reply to the show cause notice was received through letter dated December 24, 2002. In order to provide an opportunity of personal hearing, the case was fixed on May 20, 2003. Mr. Shafqat Raza, ACA appeared at the time of hearing and argued the case. At the time of hearing, Mr. Shafqat Raza assumed full responsibility for the audits of the Company and admitted that he had signed the audit reports on the accounts for the years ended June 30, 2001 and 2002.

10. In the submissions in writing and at the time of the hearing, Mr. Shafqat Raza, ACA made the following contentions:

- i) The auditors were unaware of the petition for winding up of the Company or appointment of the liquidator and in its absence there was no reason to question the validity of going concern assumption;
- ii) There is no irregularity regarding classification and provisioning of assets and the same were dealt in accordance with the provisions of Prudential Regulations. At the time of hearing, however, Mr. Shafqat Raza agreed that the Company incorrectly recognized the income of Rs. 19.848 million.
- iii) Rate of Mark up on running finance facility was not disclosed due to the reason that the facility had expired and was not renewed;
- iv) The auditors were not aware of the penalties imposed on the Company by the Commission;
- v) No staff retirement benefit scheme existed, therefore, no disclosure was required;



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- vi) Full disclosures were made in accordance with the requirements of International Accounting standards and Fourth Schedule to the Ordinance.

11. The arguments advanced by the auditors need some discussion in the light of relevant legal provisions. Mr. Shafqat Raza has argued that he was not aware of the proceedings for winding up of the Company. Moreover, there was nothing unusual to question the validity of the going concern assumption. These assertions, in my view are untenable, for the following reasons:

- i) Even after the issuance of the show cause notice to the auditors on *November 28, 2002* wherein it was expressly stated that the winding up of the Company was initiated and official liquidator had been appointed by the Honorable Lahore High Court, the review report made by the auditor on the half-yearly accounts of the Company for the period ended December 31, 2002, which was signed on *February 25, 2003* did not bring the issue of going concern to the notice of the shareholders. For ease of reference the review report is reproduced hereunder:

REVIEW REPORT TO THE MEMBERS

“We have reviewed the annexed balance sheet of M/s. Prudential Discount & Guarantees House Limited at December 31, 2002 and the related profit and loss account, cash flow statement and statement of changes in equity together with the notes forming part thereof, (hereinafter referred to as the “Financial Statement”) for the year then ended. These financial statements are the responsibility of the Company’s Management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Auditing applicable to review engagements. This standard required that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

The corresponding figure of profit and loss account, cash flow statement and statement of changes in equity and the notes forming part thereof have not been reviewed.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements are not presented fairly, in all materials respects, in accordance with the approved accounting standard as applicable in Pakistan.”



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The accounts for the half-year ended December 31, 2002 were prepared on going concern basis and reviewed by Rao & Co., The review report was signed on February 25, 2003 much after the receipt of the show cause notice dated November 28, 2002 from the Commission. It is now abundantly clear that even after the receipt of show cause notice, the auditors have not taken any cognizance of the going concern problem and deliberately and intentionally avoided to report the factual position to the shareholders.

- ii) Even otherwise, strong indicators such as the company not reporting any legally recognizable income in the years 2001 and 2002 and all its earning assets being either doubtful or under litigation, existed at the time of signing of his report, which clearly suggested that the going concern assumption was no longer appropriate.

12. During the course of hearing, Mr. Shafqat Raza was asked as to whether he had followed the requirements of Auditing Standard, ISA-23 (going Concern) to form a judgment on the appropriateness of the going concern assumption. His response was that he had placed reliance on the management representation letter only. 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:



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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.
- 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.

13. 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.



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- 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.

14. Mr. Shafqat Raza, ACA has 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. He has not followed these procedures while conducting the audit of the Company and reporting on its accounts. 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 the case in hand, an inspection report as of June 30, 2001, in respect of inspection of the Company carried out by State Bank of Pakistan was also available wherein serious reservations regarding the going concern assumption were expressed. To understand the extent of the reservation



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expressed in the State Bank Inspection Report, its concluding paragraph is reproduced hereunder:

“The overall position of the institution was assessed as unsatisfactory which resulted from gross negligence shown by the BODs and non-existence of proper management since long. The PD&GH sustained heavy losses since long due to imprudent leading activities. Cash flow of NBFIs badly disrupted, as credit facilities were concentrated into few borrowers, who were non-performing and as consequence, operations of the company have been curtailed to an extent where the institution could not take any business during the year under review. The continuity of the said NBFIs as a going concern is considered doubtful. 100% of its loans were classified in the loss category and the securities held against these facilities were either illiquid or non-recoverable. Besides, the remaining earning assets of the institution were not even close to breakeven.”

Mr. Shafqat Raza has admitted that he had neither seen nor demanded the SBP’s inspection report. This report could have been very helpful for him while dealing with the going concern issue.

15. 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 was no more a going concern on the date of signing of the audit reports on the accounts. There were several indicators, which have already been discussed in the preceding paragraphs that could have confirmed the inappropriateness of going concern assumption. The accounts, however, failed to portray the uncertainty that the company was not a going concern. In the circumstances, it was the duty of the auditors to have brought this fact and violation of International Accounting Standards to the knowledge of the shareholders in his reports. In this respect, the following guidance contained in Para 35 of Auditing Standard 23 (Going Concern), is most relevant:

“If, in the auditor’s judgment, 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 the going concern basis.”



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16. As regards the recognition of an amount of Rs. 19.848 million as mark-up income during the year ended June 30, 2001 from negotiable instruments purchased/discounted in contravention with the statutory requirements, Para 1 of Prudential Regulation VIII (Classification and Provisioning of Assets) issued by State Bank of Pakistan (SBP) requires that where mark-up/interest or principal is overdue by ninety or more days from the due date, unrealized mark-up/interest be credited to suspense account and not to be credited to income account except when realized in cash. Further, Para 3 of the said regulations, requires that the rescheduling/restructuring of non-performing loans shall not change the status of classification of a loan/advance etc. unless the terms and conditions of rescheduling/restructuring are fully met for period of at least one year (excluding grace period, if any) from the date of such rescheduling/restructuring. As the negotiable instruments against which the income was accrued were either overdue or under litigation any such accrual constitutes a violation of the Prudential Regulations. The course of action to be adopted by the auditor in case a company violates the law is provided in Para 35 of Auditing Standard 31, which requires that if the auditors conclude that the noncompliance has a material effect on the financial statements, the auditors should *express a qualified or an adverse opinion*. Mr. Mr. Shafqat Raza, ACA, at the time of the hearing agreed that the income was accrued in violation of the Prudential Regulations of SBP. The wrongful disclosure of income amounting to Rs. 19.848 million assumes even greater significance due to the reason the said amount constituted the major portion of the operating income of the Company reported in the year ending June 30, 2001. Thus, these transactions had a material effect on the financial statements of the Company. In view of the above discussion, the statement of the auditors that the accounts presented a true and fair view is incorrect and misleading.



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17. A regard to the contention that rate of mark up was not disclosed as the running finance facility had expired, I have noted that the Company has not paid the said facility and overdue amount was reflected in the audited accounts for the year ended June 30, 2002. The Company was, therefore, required to provide disclosure as per requirement of Clause (ii)(a) of Para 12B of Part II of the 4th Schedule to the Ordinance. Regarding disclosure of the staff retirement benefits, it has been observed that the Company had an approved Provident Scheme for all its permanent employees. It was, therefore, necessary to provide disclosure as required by IAS-19 (Employee Benefits). Mr. Shafqat Raza has not specifically replied to the other disclosure issues raised in the show cause notice. I, therefore, infer that he has nothing to argue in respect of these issues.

18. 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. 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.

19. 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



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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 the fail 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.

20. 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



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could shake the confidence of the stakeholders. This could also have adverse impact on the investment climate and economy of the country.

21. 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 Rao & Co. to have drawn attention to the members of the Company 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 to the Company's accounts.

22. 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 Mr. Shafqat Raza, ACA has signed the audit reports otherwise than in conformity with the requirements of Section 255 of the Ordinance. These reports also failed to bring material facts about the affairs of the Company. Besides, these reports contained false and misleading representations and statements. An action, therefore, is necessary and I, therefore, impose a fine of Rs 4,000 (Rupees four thousand only) on Mr. Shafqat Raza, ACA for making default under Sub-section (1) of Section 260 of the Ordinance with regard to his reports for the years ended June 30, 2001 and 2002. As has already been discussed earlier, since Mr. Shafqat Raza has assumed sole responsibility of the audits of the Company, therefore, no fine is imposed on Mir Muhammad Razvi, FCA and Mr. Nisar Ahmed, FCA.



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23. Mr. Shafqat Raza, ACA is directed to deposit the fine of Rs. 4,000/- (Rupees four 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 a receipted challan to the Securities and Exchange Commission of Pakistan.

24. 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 24, 2003
Islamabad