Securities and Exchange Commission of Pakistan
Enforcement and Monitoring Division

[Islamabad]

Before Rashid Sadiq, Executive Director

Order

In the matter of

M/S Rao & Company, Chartered Accountants

[UNDER SUB-SECTION (1) OF SECTION 260 READ WITH SECTION 255 AND SECTION 476 OF THE COMPANIES ORDINANCE, 1984]

Number and date of notice	EMD/Co./EA/233/601/2002 dated November 21, 2002
Date of hearing	January 21, 2003
Present	Mr. Shafqat Raza, ACA
Date of Order	June 27, 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 Hashmi Can Company Limited (hereinafter referred to as the "Company") on the accounts and books of accounts and balance sheet and profit and loss account otherwise than in conformity with the requirements of Section 255 of the Ordinance.

2. M/S 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 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, 2002. The report was signed on September 27, 2002.

4. The Enforcement and Monitoring Division conducted an examination of the financial statements of the Company for the year ended June 30, 2002 and the following deficiencies and irregularities were noticed:

i. Equity of the Company is negative by Rs. 11.239 million against paid up capital of Rs. 16.335 million. Accumulated losses of the Company stood at Rs. 29.244 million, current liabilities exceeded its current assets By Rs. 19.3487 million. These circumstances gave rise to significant doubt regarding the Company's ability to continue as a going concern, however, the Company did not provide any explanation in this regard as to why the Accounts were prepared on going concern basis.

ii. The provident fund contributions were not being paid by the Company to the Provident Fund Trust and instead, huge loans were taken from Provident Trust Fund in contravention of the provisions of Section 227 of the Ordinance.

iii. Contingencies and commitments included a liability regarding payment to the terminated workers, however, disclosure of the basis on which the management believed that the possibility of payment to the terminated workers was remote, the grounds for payment to 105 such workers and the reasons as to why the rest of 200 workers were not paid had not been provided as required by Para 86 of IAS 37 (Provisions and Contingencies & Commitment).

iv. The Company has included an amount of Rs. 2.13 million in trade debtors receivable from M/s Sunshine Cloth Limited, which were unsecured and considered good. The said company was under liquidation since 1998. No impairment loss has been recognized in violation of IAS 39.

v. The Company has not followed the following disclosure requirements of the International Accounting Standards and Fourth Schedule to the Ordinance:

a) Other Income has been offset by loss on disposal of fixed assets and exchange loss contrary to the requirements of per para 34 of IAS 1 (Presentation of Financial Statements).
b) Disclosure requirement of segment reporting as paras 55, 56 and 57 of IAS 14 (Segment Reporting) were not met.
c) The carrying amount of each class of revalued property, plant and equipment that would have been included in the Accounts, had the assets been carried at cost less accumulated depreciation has not been disclosed as per para 64 (e) of IAS 16 (Property Plant & Equipment).
d) The mode in which provident fund contributions have been invested has not been disclosed in contravention to para 10 (C) of part II of Fourth Schedule to the Ordinance.
e) Disclosure of Earnings Per Share has not been shown on the face of profit & loss account in violation of para 47 of IAS 33 (Earning per Share)
f) Statement of compliance with IAS has not been disclosed in the Accounts as per para 11 of IAS 1.
g) Accounting policies for the following have not been disclosed in the annual accounts:
    a. Borrowing costs.

b. Revenue recognition for interest and rental income.
c. Bad debts.
d. Taxation, Current and deferred.
e. Foreign exchange translation.

5. 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, 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. 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.

6. 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, 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.

7. Consequently a notice dated November 21, 2002 was issued to Rao & Co. to show cause as to why action may not be taken against them for the contraventions of the mandatory provisions of law. 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 January 21, 2003 on which date, Mr. Shafqat Raza appeared and admitted that he signed the audit report on the accounts and assumed the sole responsibility of audit of the Company and report on the Accounts. He admitted his defaults and requested for a lenient view on the assurance that he would perform his duties with reasonable care and skills in future. I have heard Mr. Shafqat Raza and also carefully perused the documents placed on record and the relevant provisions of law. My views on each of the submissions are as follows:

i) On the going concern issue, the auditor had contended that this assumption was valid as there were no possibility of the closure of the Company. 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:

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.

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 sand 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.

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. In fact the justification on the going concern issue provided along with the management representation letter is nothing more than a play of words and mainly highlights the past performance of the company. Moreover, the management's claims that the company is on a turnaround are not substantiated by the figures reported in the Profit & Loss Account for the period ended June 30, 2002. The sales of the Company has decreased from Rs. 67.109 million in 2001 to Rs. 54.866 million in 2002, gross profit has shrunk from Rs. 12. 424 million in 2001 to Rs. 7.506 million in 2002 and operating loss has increased from Rs. 5.622 million in 2001 to Rs. 8.896 million in 2002.

The entity's continuance as a going concern for the period exceeding one year is assumed in the preparation of financial statements. 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.

ii) The provisions of the law in respect of provident fund contributions have clearly been laid out in Section 227 of the Ordinance. The law requires that all moneys contributed by the employees as well as the company's contributions including the profit thereon must be deposited within 15 days of the contributions in securities referred to in Clause (a) to (c) of Sub-section (2) of Section 227 of the Ordinance. When a Trust has been created by a company with respect to any Provident Fund, the company has an obligation to pay the contributions including its own contributions to the trustee within fifteen days from the date of collection. It is therefore, amply clear that the Company has violated the provisions of Section 227 of the Ordinance. 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*, however, the auditor has failed to do so.

iii) As regards the classification of debt receivable from a company under liquidation is concerned it is matter of general understanding that debt can only be considered good if chances of its recoverability exit. In case of a company under liquidation the proceeds from the sale of assets are used to settle the liabilities of the Company wherein Government dues and loans from financial institutions take precedence over the other liabilities and sundry creditors. Therefore, it is not prudent to classify such a receivable as recoverable on a verbal assurance or some mutual understanding.

iv) Furthermore, the reply to regarding violation of IAS 14 regarding non-reporting of segment assets and liabilities is not satisfactory either as IAS 14

does not permit such exception. In fact it is stated in para 35 of IAS 14 that a business segment should be identified as a reportable segment if majority of its revenue is earned from sales to external customers and its *assets are 10% or more of the total assets of all the segments*. Therefore, if the assets and liabilities of the segments have such minimal values reportable segments should have been re-identified.

v) The submissions of Mr. Shafqat Raza regarding contravention of IAS 1 with regard to offsetting of income and expenses is not tenable either as gross amounts of income and expenses which are not permitted to be offset are to be disclosed on the face of the profit and loss account.

vi) Moreover, the reason for non-disclosure of carrying amount of revalued assets at cost less accumulated depreciation is not unsatisfactory either because even if only land had been revalued its cost was required to be disclosed.

vii) As regards other non-disclosures Mr. Shafqat Raza has himself admitted default at the time of the hearing.

8. It is clear from the above discussion that the auditor are under statutory obligations to give 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. His representations and statements in the audit report were false and misleading.

9. Before deciding this case, I deem it necessary to make some observations on the role of auditors of a company. The auditors being the ultimate watchdog of the shareholders interest are required to give a report on the accounts and books of account after conducting the audit in accordance with the prescribed procedures and requirements of the Ordinance, International Accounting and Auditing Standards. If they find any irregularity, which is material with regard to those accounts, they are required to issue a 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.

10. The duties and responsibilities of an auditor appointed by the shareholders under Section 252 of the ordinance can best be understood if we look at the place of an auditor in the scheme of the company law. The capital required for the business of a company is contributed by its shareholders who may not necessarily be the persons managing the company. In the case of a listed company, the general public also contributes towards the equity of the company. Such persons do not have any direct control over the company except that they elect directors for a period of three years and entrust the affairs of the company to them in the hope that they will manage the company to their benefits. The shareholders are, therefore, the stakeholders and the ultimate beneficiaries. Practically, however, the shareholders have no control over the way their company is managed by the directors appointed by them. It was, therefore, necessary that there must be some arrangement in place whereby the shareholders who are the real beneficiaries must get some independent view as to how the directors have managed the affairs of the company. The law, therefore, recognizing this situation, has provided that the shareholders should appoint an auditor who shall be responsible to audit the accounts and books of account and make out a report to them at the end of each year. This is the only safeguard provided by law to the shareholders to ensure that the business is carried on by the directors in accordance with sound business principles and prudent commercial practices and no money of the company is wasted or misappropriated. The law, therefore, make the auditors responsible in case 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.

11. In view of the forgoing, the lapses, irregularities, non-compliances and deliberate acts on the part of the auditors cannot be taken lightly. After careful consideration of the conduct of the auditors of the Company and the particular

circumstances of this case, I am of the view that Mr. Shafqat Raza, ACA has signed the audit report otherwise than in conformity with the requirements of Section 255 of the Ordinance. Besides, these reports contained false and misleading representations and statements. An action is necessary and I, therefore, impose a fine of Rs 2,000 (Rupees two thousand only) on Mr. Shafqat Raza, ACA for making default under Sub-section (1) of Section 260 of the Ordinance with regard to his report on the accounts of the company for the year ended June 30, 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.

12. Mr. Shafqat Raza, ACA is directed to deposit the fine of Rs. 2,000/- (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.

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

Rashid Sadiq
Executive Director (Enforcement & Monitoring)

Announced
June 27, 2003
Islamabad