Securities and Exchange Commission of Pakistan
(Enforcement & Monitoring Division)

[Islamabad]

Before Rashid Sadiq, Executive Director

Order

In the matter of

M/S F.R. MERCHANT & CO., 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/233/191/2002 dated November 21, 2002
Date of final hearing	June 30, 2003
Present	Mr. Zafaruddin Siddiqui (Authorized Representative)
Date of Order	June 30, 2003

This Order shall dispose of the show cause proceedings initiated against the partners of M/S F.R. Merchant & Co. Chartered Accountants under Section 260 of the Companies Ordinance, 1984 (the “Ordinance”) for making reports to the members of M/S Shafiq Textile Mills Limited (hereinafter referred to as the “Company”) on the accounts and books of account and balance sheets and profit and loss accounts of the Company otherwise than in conformity with the requirements of Section 255 of the Ordinance.

2. M/s F.R. Merchant & Co. Chartered Accountants is a partnership firm and the partnership comprises of Mr. Fida Hussain R. Merchant and Mr. Fakhar uddin Yousafali. Both of them are Fellow members of the

Institute of Chartered Accountants of Pakistan (the "ICAP') and were registered with the ICAP on December 14, 1961 and July 01, 1961 under Registration Numbers 177 and 135 respectively. The firm has offices in Lahore and Karachi.

3. The relevant facts for the disposal of this case, briefly stated, are that M/S F.R. Merchant & Co., Chartered Accountants have been the Auditors of the Company for the last several years, the latest appointment was made by the shareholders in the Annual General Meeting of the Company held on June 30, 2001. They have audited the accounts and books of accounts of the Company for the years ended September 30, 1998, 1999, 2000 and 2001 and have issued unqualified/ clean reports, free of any reservation to the members of the Company.

4. The Enforcement and Monitoring Division conducted examination of the financial statements of the Company for the years ended September 30, 1998, 1999, 2000 and 2001 (the "Accounts") and it appeared that the going concern assumption used in the preparation of the financial statements was not appropriate due to the fact that the operations of the Company were closed since August 1998, the Company had negative capital and reserves; its accumulated losses as of September 30, 2001 amounted to Rs.71.471 million, which has not only eroded the paid up capital and reserves but also depicted a negative equity of Rs.57.215 million; the Company's current liabilities in all these years were in excess of current assets, the current liabilities as of September 30, 2001 exceeded current assets by Rs.42.572 million; the lenders have filed recovery suits

against the Company and the Company had sold all of its plant machinery; the only significant assets shown in the balance sheet were leasehold land and building thereon.

5. It was also noticed from the directors' reports appended to the financial statements for the years ended September 30, 1998, 1999, 2000 and 2001 that the directors did not mention any strategy to overcome the problems being faced by the Company, particularly the repayment of huge debts and the recovery of huge losses. For ease of reference the contents of the directors' reports are reproduced hereunder:

<u>FOR THE YEAR ENDED SEPTEMEBR 30,1998</u>

"Due to various unavoidable circumstances beyond their control, the management was forced to close the mills from August 1998 for some time to avert the difficult period."

<u>FOR THE YEAR ENDED SEPTEMBER 30, 1999</u>

"Due to various unavoidable circumstances beyond their control, the management was forced to close the mills from August 1998. However, the situation do not improve during the year under review and it was <u>not considered feasible to restart the mills, as it would have increased further losses."</u>

<u>FOR THE YEAR ENDED SEPTEMBER 30, 2000</u>

"As already informed in previous report that due to various unavoidable circumstances beyond their control, the management was forced to close the mills from August 1998. As per the Orders of the Honorable High Court of Sindh, most of the machinery has already been sold out during the period under review."

<u>FOR THE YEAR ENDED SEPTEMBER 30, 2001</u>

"The management has been successful in generating other source of income to the Company in order to bring your Company out of continuous heavy losses and start earning good profit once again inspite of the fact that over all economic conditions were not favorable. The management of your Company is keenly watching the conditions of the local as well as foreign markets and planning to start the export trade as soon as possible to generate more business and more profit"

In all these years, the financial statements on which the auditors issued reports did not indicate the uncertainty of going concern assumption.

6. It was also observed from the perusal of the Accounts that the following disclosure requirements of the International Accounting Standards (IAS) and the Fourth Schedule to the Ordinance were not followed in regard to preparation of the balance sheet and profit and loss account of the Company for the year ended September 30, 2001:

- Nature of Capital Work in Progress amounting to Rs.19,850,000 has not been provided as per the requirement of Clause 2 of Part II of the Fourth Schedule of the Ordinance. Furthermore, the Company on an enquiry of the Commission has stated that it includes compensation expenses paid to the workers and repairs and re-construction of building expenditures, which are not of the nature of Capital Work in Progress. This treatment is against the General Accepted Accounting Practices and the provisions of law.

- Depreciation on fixed assets has not been provided as per the requirements of Para 41 to 44 of IAS 16 (Property, Plant & Equipment) and Technical Release (TR) 11 –Depreciation on Idle Assets.

- Statement of changes in equity has been included in the notes to the aforesaid accounts contrary to the requirements as per Para 86 of IAS 1 (Presentation of Financial Statements), which requires that statement of changes in equity shall be a separate component of the financial statement.

- The Company has been disclosing gain on the sale of the plot of land amounting to Rs.1,755,674 as revenue reserve since several years in contravention to Para 56 of IAS 16 (Property, Plant & Equipment) which requires that the said gain or loss on sale of asset should be recognized as income or expense in the income statement.

- The contingency relating to suits filed by HBL & UBL against the Company and the suits filed by the Company against these banks were not disclosed as per the requirement of Para 86 of IAS 37 (Provisions, Contingent asset, Contingent liabilities)

- Disclosure of Interest rate risk as required under Para 56 of International Accounting Standard 32 (Financial Instruments: Disclosure and Presentation).

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

- Number of employees has not been disclosed in the financial statements as required by Para 102(d) of IAS-1.

- The accounts do not disclose that the financial statements comply with the requirement of International Accounting Standards as per the requirement of Para 11 of IAS 1 (Presentation of Financial Statements).

- The current portion of long term and over due loans is not disclosed as per the requirement of Clause (B) of Para 12 of Part II of Fourth Schedule to Ordinance.

- The Company has not charged long outstanding amount of prepaid interest/markup amounting to Rs.1,162,697 to profit and loss account which would have increased the Company's losses by the said amount.

- The domicile and the legal form of the enterprise, its country of incorporation, the address of the registered office and the description of the nature of the Company's operations and its principal activities is not disclosed as required under Para 102(a) & (b) of IAS-1.

7. In view of the aforesaid material deficiencies and irregularities, the auditor's reports on the financial statements of the Company for the years ended September 30, 1998, 1999, 2000 and 2001 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 had neither drawn attention of the members towards the going concern assumption being inappropriate in all these year 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 September 30, 2001. 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 the auditors and the audit reports made by them on the accounts for the years ended September 30, 1998, 1999, 2000 and 2001. 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.

9. Consequently, a notice dated November 13, 2002 was issued to the partners of M/S F. R Merchant & Co., Chartered Accountants to show cause as to why action may not be taken against them for the contraventions of the mandatory provisions of law. Mr. Fakharuddin Yousafali, the partner incharge of the Lahore office, in his reply dated November 26, 2002, stated that he is the partner at the Lahore office whereas the audit of the Company was carried out by Karachi office, where Mr. Fida Hussain R. Merchant is the Principal. He also added that he has nothing to do with the firm "F.R. Merchant & Co., Karachi" and pleaded that the notice against him may be withdrawn. Mr. Fida Hussain R.Merchant, however, requested for more time for the reply to the show cause notice, which was allowed. The reply to the show cause notice was

finally received on January 07, 2003 by Mr. Fida Hussain R. Merchant. Thereafter, in order to provide an opportunity to the auditors of personal hearing, the case was fixed on June 30, 2003 on which date Mr. Zaffarullah Siddiqui appeared on behalf of Mr. Fida Hussain R. Merchant and made submissions on his behalf. Mr. Zaffarullah Siddiqui confirmed that Mr. Fida Hussain R. Merchant was the engagement partner for the audits of the Company and had signed the audit reports on the Accounts and assumed full responsibility in this regard.

10. In the written submissions as well at the time of hearing of this case, some of the defaults were admitted while the auditors contested others. Mr. Zaffarullah Siddiqui admitted that there was carelessness on the part of auditors while making report in terms of Section 255 of the Ordinance. He assured that these defaults would not be repeated in future. The submissions on behalf of Mr. Fida Hussain R. Merchant can be summarized as follows:

(i) It was contended that the audit procedures applied at the time of the audit and the explanation given by the Company made the auditor believe that there was no material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern. It was further added that the Company has started generating income by letting out the space, which was vacated after the sale of the old machinery and has also been able to declare interim cash dividend at the rate of 10%. It was also submitted that the directors have not shown their intention, to close down the Company or to liquidate the enterprise in the directors' report.

(ii) As regards the disclosure of work in progress amounting to Rs. 19,850,000 it was submitted that the said amount included compensation made to some of the workers to peaceful vacate the valuable premises of the Company occupied by them. It was added that the said disclosure would cause adverse effect and instigation to the remaining occupants and would cause problems in vacating the premises.

(iii) As regards to other deficiencies and irregularities, Mr. Zafarullah Siddiqui either admitted the defaults or has not been able to give any satisfactory reply.

11. I have heard Mr. Zafarullah Siddiqui and have also gone through his submissions and the relevant provisions of law and the material placed on record. The arguments advanced by the auditors need some discussion in the light of relevant legal provisions. Circular No. 11/2002 dated November 11, 2002 issued by ICAP provides guidance to the auditors on the reporting on Going concern assumption. The said circular clearly spells out the following indicators which suggest material uncertainty regarding the appropriateness of the going concern assumption:

- Negative capital and reserve,
- Current liabilities in excess of current assets,
- Default in repayment of debt installments,

I have noticed that that the accounts did not give any indication as to the going concern uncertainty. Moreover, the directors' report in all these years did not mention any strategy to overcome the liquidity problem and the plans to manage the repayment of debt and recovery of huge losses. In my view the auditors have failed in their duty to address the issues of going concern in the report to the shareholders. There were significant indications to suggest the uncertainty regarding the appropriateness of going concern assumption, however, the accounts were prepared on going concern basis. The auditor, thus, has failed to take reasonable level of care while performing the work for the shareholders who they are accountable.

12. During the course of hearing, when Mr. Zafarullah Siddiqui 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, he could not give an appropriate response. He, however placed on record the letter of the Company dated December 24, 2002 which highlights the management's contentions on the going concern issue on the accounts for the subsequent year ended September 30, 2002. In the aforesaid letter, the management assessed that the Company was a going concern. This letter is with regard to the audit of subsequent year ended September 30, 2002. The management in the said letter has also tried to justify the appropriateness of going concern assumption by stating that the auditors have never highlighted the going concern issue in the year 2000 and 2001 where there was no substantial regular source of income. This further strengthens my apprehension about the failure of the auditors to bring the issue of going concern uncertainty to the shareholders of the Company in all these years. 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.

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.

- 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.

14. 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 status was as a going concern was uncertain on the date of signing of the audit reports on the accounts as it has suspended its business since 1988, lenders had filed recovery suits, disposal of all pant and, machinery etc etc., 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. As they have not followed the requirements of Auditing Standard 23 while dealing with the going concern issue, their statement in their audit report that they

have conducted audited in accordance with the auditing standards as applicable in Pakistan is untrue and misleading.

15. As regards to the nature of the work in progress amounting to Rs. 19.850 million I have noted that the same was not disclosed as per the requirements of the Fourth Schedule. The requirement of Clause 2 of Part II of Fourth Schedule is reproduced hereunder:

> " (f) Capital work in progress indicating significant item-wise details."

It was stated that capital work in progress included payments of compensation made to some of the workers and the said disclosure in the accounts would cause adverse effect and instigation to the remaining occupants who would demand for the extraordinary compensation to vacate the premises. Moreover, it also included the expenditures incurred on the reconstruction of the building and expenses on the sale of the machinery. I am of the view that mandatory disclosure requirements of law must be followed and if the auditors find any deficiencies, it is their duty to bring the same to the notice of the shareholders. In this case, there is no information available in the accounts about Rs. 19.850 million spent by the Company. This amount has also increased in the subsequent year to Rs. 27.9 million and I have noted that the subsequent accounts also fail to give the mandatory disclosure. Incurring of such a huge expenditure when the Company has closed its operations is also open to questions. Besides this information / detail was suppressed from the shareholders. As regard to the other issues raised in the show cause notice, Mr. Zafarullah

Siddiqui admitted the default and pleaded for a lenient view on the assurance that such defaults would not be repeated.

16. 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.

17. 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.

18. 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.

19. 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 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.

20. As the Auditor has admitted the defaults and has not been able to give any justifiable argument for the same, therefore, I consider it a deliberate act which is certainly more than mere omission and default on the part of Mr. Fida Hussain R. Merchant who was under legal obligation to perform his duties, in the course of audit of Accounts of the Company and reporting thereon, in accordance with the provisions of the Ordinance, International Accounting Standards and Auditing Standards. Mr. Fida Hussain R. Merchant has, therefore, made himself liable for punishment under Sub-section (1) of Section 260 of the Ordinance.

21. For the reasons stated above, I impose a fine of Rs. 8,000/- (Rupees eight thousand) under Sub-section (1) of Section 260 of the Ordinance on Mr. Fida Hussain R. Merchant for making reports otherwise than in conformity with the requirements of Section 255 of the Ordinance on the financial statements of the Company for the year ended September 30, 1998, 1999, 2000 and 2001. As has already been discussed earlier, Mr. Fida Hussain R. Merchant has assumed sole responsibility of the audit of

the Company; therefore, no fine is imposed on Mr. Fakhar uddin Yousafali.

22. Mr. Fida Hussain R. Merchant 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.

23. 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 30, 2003
ISLAMABAD