Corporate Supervision Department
Company Law Division

Before Mr. Tahir Mahmood – Commissioner (Company Law Division)

In the matter of

**Mr. Farrukh Rehman Partner A.F. Ferguson & Co. Chartered Accountants
Auditor of National Refinery Limited**

Number and date of notice:	EMD/233/406/2002-1042 dated January 30, 2015
Date of hearing:	April 06, 2015
Present:	Mr. Farrukh Rehman - Partner A.F. Ferguson & Co. Chartered Accountants

ORDER

UNDER SECTION 260 READ WITH SECTION 476 OF THE COMPANIES ORDINANCE, 1984

This order shall dispose of the proceeding initiated against Mr. Farrukh Rehman partner of A.F. Ferguson & Co. Chartered Accountants through show cause notice (the "SCN") dated January 30, 2015 under the provisions of Section 260 read with Section 476 of the Companies Ordinance 1984 (the "Ordinance").

2. The brief facts of the case are that review of annual audited financial statements of National Refinery Limited ("the Company") for the year ended June 30, 2013 ("Accounts-2013") audited by A.F. Ferguson & Co., Chartered Accountants (the "auditor"), revealed that the Company has accounted for change in valuation basis of 'stock in trade' (Cost formula), from weighted average to First-In-First-Out (FIFO) basis, as a change in 'accounting estimate'.

3. International Accounting Standard (IAS) 8, 'Accounting Policies, Changes in Accounting Estimates and Errors' (IAS-8) in para 35 classifies change in the measurement basis as change in accounting policy. According to IAS-8, change in accounting policy has to be accounted for retrospectively and change in accounting estimate requires a prospective application. The Company has applied the said change prospectively in the Accounts-2013 of the Company. The aforesaid prospective application had resulted in overstatement of net profit for the year 2013 by Rs. 206.891 million. The Company in its letter dated July 8, 2014 had confirmed the said amount of effect on the profit of the Company. The Accounts-2013 of the Company appears to be misstated due to the prima facie, deviation with the requirements of IAS-8.

4. Para A6 of 'Application and Other Explanatory Material' to the International Standard on Auditing ("ISA") 705 "Modifications to the Opinion in the Independent auditor's report" states

that in relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:

(a) *When management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or*

(b) *Due to the method of application of the selected accounting policies (such as an unintentional error in application).*

Para 6 of the ISA 705 states that the auditor shall modify the opinion in the auditor's report when:

(a) *The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or (Ref: Para. A2–A7)*

(b) *The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. (Ref: Para. A8–A12)*

Para 7, 8, 9 and 10 of the ISA 705 prescribe the criteria for determining the type of modification to the auditor's opinion.

5. The Auditor while making out their report to the members did not modify the opinion in the auditor's report despite the fact that the Accounts-2013 were materially misstated. The audit report on the Accounts 2013 was prima facie, not in accordance with the requirements of Section 255 of the Ordinance and International Standards on Auditing ("ISA") and the auditor failed to bring out material facts about the affairs of the Company. Therefore, SCN was issued to the auditor for *prima facie,* contravention of Section 260 of the Ordinance.

6. The reply to SCN was submitted by the auditor vide letter dated February 12, 2015. The seriatim reply is summarized below.

- At the IASB level it is acknowledged that the guidance provided in the standards it is not clear what constitute a change in the measurement basis, in particular whether a change in historic cost bases is a change in the measurement basis (for example, from FIFO to a weighted average method) or merely a change in accounting estimate and the auditor provided related staff paper of the IFRS foundation.

- The auditor relied on paragraph 35 of IAS 8 which states that when it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.

- Under the requirements of IAS 705 modification of auditor's report is made only in case of material misstatements. The total equity of the Company was over Rs. 25 billion and there would have been no change in the equity of the Company had a retrospective treatment of the change in inventory valuation was done. Further the details of the change and the impact of the change on the profit of the company for the year ended June 30, 2013 was appropriately disclosed in the financial statements. The impact on profit for the year, in case of retrospective treatment, was about 200 million which was less than 1% of the equity and less than 10% of profit for the year.
- Under these circumstances modified opinion on the financial statements of the company for the year ended June 30, 2013 was not appropriate and requested that no action as specified under Section 260 of the Ordinance should be taken against the auditor.

7. In this regard, opinion of the Institute of Chartered Accountants of Pakistan ("ICAP") was sought and as per their technical opinion dated April 15, 2014, change in the cost formula from a weighted average cost formula to FIFO – based cost formula or vice versa is a change in accounting policy. The change in the cost formula represents a change in the bases on which the value of the inventory has been determined. Therefore, a change in the cost formula represents a change in the specific bases and hence will be treated as a change in the accounting policy.

8. In order to provide opportunity of personal hearing; the case was fixed before the undersigned on April 6, 2015. Mr. Farrukh Rehman appeared and maintained the same plea as per written submissions. He also submitted that with respect to balance sheet the amounts, as alleged to be misstated are not material.

9. Before proceeding further, it is necessary to advert to the following relevant provisions of Section 260 of the Ordinance, which states as under:

> *If any auditor's report is made, or any document of the company is signed or authenticated otherwise than in conformity with the requirements of section 157, section 255 or section 257 or is otherwise untrue or fails to bring out material facts about the affairs of the company or matters to which it purports to relate, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document, and in the case of a firm all partners of the*

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firm, shall, if the default is wilful, be punishable with fine which may extend to one hundred thousand rupees.

10. I have analyzed the facts of the case, relevant provisions of the Ordinance and ISA, arguments put forth by the auditor in writing and during the hearing. However, due to the following facts, I am of the view that changes in cost formula from weighted average to FIFO basis is a change in accounting policy:

- Para 35 of IAS-8, which is also referred in the reply, is reproduced below:

  *"A change in the **measurement basis** applied is a change in an accounting policy, and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate."*

- IAS-8 clearly provides to account for the change in measurement basis as change in accounting policy. Since nothing to the contrary is provided in IASs, therefore, the change has to be applied as change in accounting policy.

- As per ICAP, change in the cost formula from a weighted average cost formula to FIFO – based cost formula or vice versa is a change in accounting policy. The change in the cost formula represents a change in the bases on which the value of the inventory has been determined. Therefore, a change in the cost formula represents a change in the specific bases and hence will be treated as a change in the accounting policy.

- The discussion papers submitted by the auditor are prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretation Committee but suggestions in the discussion paper are not yet enacted or part of IAS 8. Following disclaimer was provided in discussion paper:

  "This paper has been prepared by the staff of the IFRS foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS – only the IFRS interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretation Committee are reported in IFRIC Update. The approval of a final interpretation by the Board is reported in IASB Update."

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- Incorrect accounting of change in cost formula in the Accounts-2013, as change in accounting estimate (prospective accounting) instead of as a change in accounting policy has resulted in overstatement of net profit for the year 2013 by Rs. 206.891 million, which is 7% of profit for the year .

- The powers of the Commission are exercised in the best interest of all the stakeholders, circumstances of each case warrants relevant decision based on merit and adherence to the well-settled principles of natural justice and available records.

11. For the foregoing reasons, I am of opinion that the auditor failed to bring about material facts about the affairs of the Company and accordingly auditor's report has not been made in conformity with ISA 705 and Section 255 & 260 of the Ordinance. However, the auditor has demonstrated that the omission from the auditor's report regarding treatment of change as an estimate rather than policy, was not due to oversight, rather the auditor based his judgment on the basis of discussion papers of IFRS Interpretation Committee meeting and relied on para 35 of IAS 8 that when it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate. In view of aforesaid, I take a lenient view and hereby warn the auditor to ensure meticulous compliance of law in future.

Tahir Mahmood
Commissioner
Company Law Division

Announced:
July 8, 2015
Islamabad