SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
Company Law Division
(Enforcement Department)

[Islamabad]

Before Mr. Ali Azeem Ikram, Director (Enforcement Department)

In the matter of

M/s Gangat & Co., Chartered Accountants

Under Sub-Section (1) of Section 260 Read With Section 255 and 476 of the Companies Ordinance 1984

Number and date of Show Cause Notice:	EMD/233/253/2002-9484-85 Dated March 30, 2006
Date of final hearing:	September 13, 2006
Present:	Mr. Husaini Fakhruddin, Partner
Date of Order:	May 25, 2007

ORDER

This order shall dispose of the proceedings initiated under Section 260 of the Companies Ordinance, 1984 (hereinafter referred to as the "Ordinance") against the partners of M/s Gangat & Co., Chartered Accountants (hereinafter referred to as the "Auditors") for making report on 27.09.05 to the members (hereinafter referred to as the "Report") of M/s Hafiz Textile Mills Limited (hereinafter referred to as the "Company") on the accounts and books of accounts and balance sheet and profit and loss account for the period ended 30.06.2005 (hereinafter referred to as the "Accounts") of the Company otherwise than in conformity with the requirements of Section 255 of the Ordinance.

2. M/s Gangat & Co., Chartered Accountants, is a partnership firm and its partners are Mr. Ahmed Adam Gangat, FCA and Mr. Hasnain Abid Ali, ACA.

3. The Enforcement Department of this Commission conducted an examination of the Accounts of the Company to determine, among other things, whether Auditors' report pertaining to the aforesaid Accounts had been made in conformity with the requirements of Section 255 of the Ordinance, is otherwise true, contains no such statement which is materially false and there is no omission of material facts about the affairs of the company.

4. The Enforcement Department noted that the report of M/s Gangat & Co. included the following qualifications:

> *"1. We have <u>not observed physical stock taking</u> of store and spare and stock in trade.*
>
> *2. The company has <u>not carried out actuarial valuation</u>, as required by IAS – 19, in respect of gratuity dues for the reasons disclosed in note 3.1 to the accounts.*
>
> *3. The management plans to start production activities in the near future, which is <u>dependent on successful negotiations with foreign supplier and assistance from financial institutions</u> (refer note 1.2 to the financial statements). Consequently no adjustments has been made in the accounts that may be determined to be necessary, if any, to the recorded amounts and classification of assets and liabilities."*

5. The Auditors also added an emphasis of matter paragraph stating *"Without qualifying our opinion we draw attention of members' toward the fact that the "Statement of Compliance with Best Practices of Corporate Governance" <u>has not been offered for review</u>."*

6. Examination and analysis of the qualifications and emphasis of matter paragraph made by the Auditors in their report on the Accounts revealed the following:

6.1 **<u>Verification of Current Assets</u>:**

Monetary value of the assets whose existence and valuation was not verified as reported in the aforesaid qualifications amounted Rs.2.848 million which is 68.36% of the total current assets. These include stores and spares of Rs.2.729 million and stock in trade of Rs.0.119 million. Although, 68.36% current assets remained unverified yet the Auditors instead of giving an adverse opinion gave a qualified opinion and stated in their report that proper books have been kept by the Company.

6.2 **<u>IAS non-compliance</u>:**

Actuarial valuation as per IAS 19 had not been carried out with regard to the provision of gratuity amounting to Rs.1,216,850 under the account head "Deferred Liabilities".

6.3 **<u>Going Concern Assumption</u>:**

a. The Company had ceased its production activities since June 1998. Its accumulated losses as at the said balance sheet date stood at Rs. 124.889 million against a paid up capital of Rs.12 million resulting in negative equity of Rs.112.889 million. Directors have not given any tangible prospects for the revival of the Company in their reports to the members since the year of shut down of production.

The Accounts do not reflect any assistance from financial institutions and there appears no indication of positive negotiation with the foreign suppliers. These circumstances give rise to significant doubt regarding the Company's ability to continue as a going concern.

b. It has been observed while analyzing previous years' accounts that the directors' report and the accounts for the years ended 30.09.2002 to 30.09.2004 had reiterated on the above matters. This shows that the negotiations with foreign supplier and assistance from

7th Floor, NIC Building, 63-Jinnah Avenue, Islamabad
Phones: 9207091-4, Fax: 9218592, E-mail: secphq@isb.paknet.com.pk

financial institution are a long term and uncertain issue and its intensity cannot be ignored by the Auditors while expressing opinion in their report.

Moreover, the directors in their report dated 27.9.2005 to the members attached with the Accounts also stated the same:

> *"……….the Chinese machinery suppliers have already revised their prices, in view of increase in world prices. Taking that also in consideration we have started negotiations with Islamic banking financial institutions to procure funds to restart the production activities and are working on other options to arrange funds. During the period, the company has to rely on rental incomes to meet current expense; otherwise the losses would have further gone up………"*

Notes to the Accounts states:

> *"As far as the other financing is concerned to start the mill, the same will be carried out with the assistance from the financial institutions. The management believes they will have no difficulty in obtaining new working capital and fixed financing. As such the management feels that the company is therefore a going concern."*

c. The accounts were prepared on going concern basis and apparently the Company was no more a going concern yet the Auditors did not give an adverse opinion.

7. It was further revealed that the following matters pertaining to the previous years' accounts of the Company were also not considered by the Auditors while issuing audit report on 2005 Accounts:

7.1 **Prior years' adjustment and restatement for provision of tax liability and transfer of incremental depreciation**

The Company made prior years' adjustments for the unrecognized tax provision of Rs.0.6 million relating to rental income and incremental depreciation of Rs.1.258 million; however, the same issues were not brought to the attention of the members of the Company in the Auditors' report.

7.2 **Revaluation of fixed assets**

- M/s Gangat & Co. in their audit report dated 6.03.2002 issued on the accounts of the company for the year ended 30.09.2001 expressed the following qualification:

  > *"Considering the huge losses on disposal of land and building, in our opinion there is a need for revaluation of assets to ensure that the assets are carried at their recoverable amounts and provision against impairment, if any is made accordingly"*

- The directors in their report dated 6.03.2002 stated the following:

  > *"We agree with the view for revaluation of assets to ensure that the assets are carried at their realizable value in future."*

- It is pertinent to mention here that the last revaluation had been carried out by M/s. Iqbal A. Nanjee & Company in year 1995 which explicates the fact that the Company had not revalued any on its assets since 1995 till date and the Auditors kept silent about this note worthy issue in their reports on the subsequent period accounts.

7th Floor, NIC Building, 63-Jinnah Avenue, Islamabad
Phones: 9207091-4, Fax: 9218592, E-mail: secphq@isb.paknet.com.pk

8. In view of the above, the Enforcement Department got concerned with regard to the quality of audit of the Company conducted by the Auditors and the audit report given by them on the Accounts of the Company. It was observed that the Company had not justifiably explained the appropriateness of using Going Concern assumption in preparation of the Accounts and the Auditors failed to express adverse opinion regarding validity of going concern assumption as per International Standards on Auditing applicable in Pakistan.

9. Consequently, a show cause notice was issued on 30.03.2006 to all the partners of M/s Gangat & Co., Chartered Accountants, pointing out their responsibilities under the Ordinance, International Accounting and Auditing Standards and non-compliance observed in the Accounts.

10. The Auditors finally submitted their reply on 26.5.2006. In order to provide an opportunity of personal hearing, the case was fixed for 13.09.2006 on which date Mr. Husaini Fakhruddin, Partner appeared on behalf of the audit firm to represent the case before me at the time of hearing and argued the case. However, in the written submission made by him against the SCN he discussed the following matters one by one:

a. **<u>Appropriateness of going concern assumption</u>**

- The Company was in negotiation with foreign supplier and the Board of Directors, suggested raising funds through right issue.
- There are no hidden facts about the Company's intention and in the Annual General Meeting the shareholders were also informed of these facts and also disclosed in the Directors report for the year 2005. This also indicates the intention of the management to continue as going concern. Further these facts have also been disclosed in the note 1 to the financial statements.
- The company has no debts to repay and without any financial leverage, hence there was no imminent risk of defaults of any nature and neither was there a risk of foreclosure.
- On review of the cash flow statement, it can be seen that the company is generating a positive cash flow from operating activities, which shows that the company is striving to continue through other means like rental income etc.
- Therefore, the Auditors did not issue an adverse opinion regarding the going concern assumption. However as the outcome of the negotiations was not materially certain and this fact was not adequately disclosed, the Auditors' audit report was modified by qualifying and stating the uncertainty and doubt over the successful negotiation.

b. **<u>Verification of inventories and store and spares</u>**

The Auditors replied that they have adequately qualified their report on this issue.

c. **<u>Actuarial valuation with regard to gratuity</u>**

- The provision held by the company is sufficient to meet its obligation as the liability so determined is calculated by multiplying the last salary of each employee with the number of years in service.

- However as this is in non-compliance with IAS – 19 and not a material misstatement therefore, the Auditors qualified the same in their audit report.

d. **Review of Statement of Compliance with Code of Corporate Governance**

- In compliance with the International Standards on Auditing, the Auditors added an emphasis paragraph for not reviewing the compliance statement. This is not a material error or misstatement concerning the financial statement, but non-compliance with statutory responsibility by the company.
- The management of the Company decided not to incur more expenditure on paying review fee and decided not to offer the compliance statement for review.

e. **Revaluation of assets**

- In 2001 the same was qualified as was affecting the retained earning and profit/loss of the company for that year. Since then there have been no sale of assets and no charge to the equity and reserves therefore not referred in audit report.
- Further the qualification No. 2 in audit report clearly mentions that no adjustments to the recorded amounts and classification of assets and liabilities have been made. As such the Auditors have identified that assets may require adjustment to their recorded values.

f. **Restatement in respect of provision of tax liability**

- The error for not providing tax liability of the Company for the year was identified by us in 2005 and was rightly corrected by restating the financial statements. Had the same was not corrected; our report would have been qualified in this respect.
- Reference in audit report is only required when there is a material misstatement which remains uncorrected, as the correction of error was made and restatement done, no reference was made in the audit report for the year 2005.

g. **Restatement in respect of transfer of incremental depreciation for 2004**

- The SRO 45/ (I)/2003 was overlooked while issuing the audit report for 2004. As the same came to their attention in 2005 they discussed the same with the management who agreed and restated the figure of 2004 in the year 2005 accounts.
- There is no loss none so ever that was sustained by the Company or its shareholders due to this innocent mistake. In fact this transfer does not even affect the profit and loss account; it is just a transfer from one reserve (i.e. surplus on revaluation of fixed assets accounts) to another reserve (i.e. accumulated loss).
- The immateriality of amount in question and correction made in 2005, is not considered a material error which still remains unaddressed by the Auditors, as the same was adequately dealt with in the 2005 financial statements.

11. The Auditors have further submitted that as far as the penalty is concerned, section 260 of the Company Ordinance, 1984 provides for a penalty only if 'material facts' about the affairs of the Company are not disclosed. Further the penalty under section 260 could only be imposed if the default is willful. In the Auditors' case all material facts have been addressed and disclosed by way of qualification and

7th Floor, NIC Building, 63-Jinnah Avenue, Islamabad
Phones: 9207091-4, Fax: 9218592, E-mail: secphq@isb.paknet.com.pk

reference to the relevant notes in the financial statement, as such the Auditors are of the opinion that no penalty shall be imposed on them.

12. I have taken into consideration the submissions, made in writing as well as those at the time of hearing of this case and am of the view that most of the grounds taken by the Auditors are not convincing due to the following reasons:

a. <u>Stock of inventories and stores and spares</u>

- The first most qualification with regard to the non-observance of physical stock taking of stores and spares and stock in trade was given in the Auditors' report on the accounts for the year ended 30.09.2001 and repeatedly given again for the subsequent audit reports on the following accounts until the financial period ended 30.06.2005.
- The monetary value of the assets as at 30.06.2005 whose existence and valuation was not verified amounted to Rs.2.848 million which is 68.36% of the total current assets.
- This matter required an adverse opinion of the Auditors as it had been a material issue since year 2001 until now. Furthermore, the balance of stores and stocks had completely been provided for as obsolete which appears to be a careless handling of stocks by the Company as the same could have been disposed earlier at good price rather than just keeping it in stock for it to become obsolete and wasted at the cost of shareholders' money.
- Auditors could also not give cogent written representation to this office stating the reason as to why they were unable to verify the said stores and stocks.

b. <u>Actuarial valuation with regard to gratuity</u>

- With regard to the non-conducting of the actuarial valuation of gratuity, the Auditors when asked, could not prove through calculations that the financial impact of this non-compliance is immaterial.
- This matter required an adverse opinion of the Auditors as it had been repetitively qualified since the year ended 30.06.2001 by the Auditors.

c. <u>Going concern assumption and Auditors' responsibility</u>

- It appears from the Accounts that there was no success in negotiations with foreign suppliers and assistance from financial institutions upon which plans of the management are dependant to start production activities. In its absence the going concern assumption would become invalid as also reported by the Auditors in their report.
- The financial position of the Company appears to be deteriorating further especially due to non productive expenses like administrative expenses resulting in net loss of Rs.1.299 million before liabilities written back and taxation. Furthermore, rental income as reported by the Company in its accounts is a non-operating income and is not being earned through core operations of the business. In addition to this, it appears that the recovery of trade debtors is doubtful as the balance of Rs.2.012 million is outstanding since long and there appears to be no solid ground for its recovery as a provision of Rs.1 million for doubtful

7th Floor, NIC Building, 63-Jinnah Avenue, Islamabad
Phones: 9207091-4, Fax: 9218592, E-mail: secphq@isb.paknet.com.pk

debts has already been provided for. It is noted that this fact had also not been taken into account while assessing going concern assumption at the time of signing audit report.

- While analyzing previous years' accounts with respect to the going concern issue it is noted that in the year 2003, directors had financially supported the Company by providing interest free and unsecured long term loan of Rs.29,641,800 however it has not yet assisted the Company to come back into production.
- With reference to Para 26 of ISA 570 the Auditors have not provided appropriate audit evidence which they were required to obtain from the Company to ensure the appropriateness of Management's use of going concern assumption. The Auditors could possibly have, which they did not, obtain from the Company the following documents that were necessary to ensure appropriateness of the use of going concern assumption by the Company:
  - (i) Business proposal submitted by the Chinese machinery suppliers.
  - (ii) Proposal for right issue.
  - (iii) Any proposed financing arrangement with any bank.
- Section 305 (c) of the Ordinance states that the company maybe wound up by the Court if the company suspends its business for a whole year. Company's operations were ceased since June 1998.
- The assessment made by the management of the available information of twelve months from the balance sheet date as per Para 24 of IAS-1 appears to be inappropriate as the Company has not reported any sales in the subsequent accounts for the year ended 30.06.2006, and half year ended 31.12.2006.It has been more than 12 months since the balance sheet date 30.06.2005 on which the said audit report was issued and the operations of the Company have not revived as yet, therefore, the going concern assumption seems to be invalidly used by the Company.

  In this regard, Para 23 of IAS-1 states:

  > *"Financial statements should be prepared on going concern basis unless management either intends to liquidate the enterprise or to cease trading,……"*

  In view of the above, it appears from the Accounts that the Company has currently ceased trading and therefore going concern basis is not appropriate to be used in the preparation of the Accounts of the Company.
- It is apparent from the subsequent accounts till second quarter ended 31.12.2006 that the negotiations with foreign suppliers of machinery and the obtaining of assistance from financial institutions had not been successful at all. The subject audit report had mentioned in the reservation numbered 3 that no adjustments had been made in the accounts that may be determined to be necessary, if any, to the recorded amounts and classification of assets and liabilities based on the assumption that management plans to start activities in the near future depending on success of the said negotiations and financial assistance which has not been the case till now. The said negotiation and financial assistance as highlighted in the

7th Floor, NIC Building, 63-Jinnah Avenue, Islamabad
Phones: 9207091-4, Fax: 9218592, E-mail: secphq@isb.paknet.com.pk

Auditors report was used as basis for adopting going concern assumption. However, the Accounts and directors' report do not disclose any evidence of any such support.

- The directors of the Company did not give any future solid prospect of revival of the Company and a reasonable indication of future prospects of profit, if any, as required under Section 236 (2) (g) of the Ordinance in their report to the members. Non discussion of such important matters required Auditors' special attention.
- The Para 8 of ISA 23 gives examples which may cast significant doubt about the going concern. Based on the facts in the said Accounts and submissions made by the Auditors, the current case is among such models as below:
  - (i) Net liability or net current liability position.
  - (ii) Excessive reliance on short-term borrowings to finance long-term assets.
  - (iii) Indications of withdrawal of financial support by debtors.
  - (iv) Adverse key financial ratios.
  - (v) Substantial operation losses.
  - (vi) Arrears or discontinuance of dividends.
  - (vii) Inability to pay creditors on due dates.
  - (viii) Inability to obtain financing for essential investments.
  - (ix) Loss of major market.

  The above should have raised concerns of the Auditors and accordingly they should have expressed adverse opinion in their audit report.
- On the foregoing, I am convinced that the going concern assumption was not appropriately used by the management and the Auditors in spite of having sufficient audit evidence have failed to express adverse opinion in their audit report.

d. Review of Statement of Compliance with Code of Corporate Governance

It has been noted that the Auditors have reported the matter of non-review of the Statement of Compliance with Code of Corporate Governance through emphasis of matter paragraph in their audit report in compliance of Para 35 of ISA 700.

e. Prior years' adjustment and restatement for provision of tax liability and transfer of incremental depreciation

With regard to the adjustment for non-provision of previous years' tax liability and the restatement in respect of transfer of incremental depreciation for 2004 as mentioned in Note 4 to the Accounts, it is noted that the Auditors had not highlighted through modification of their report by adding an emphasis of matter paragraph as per Para 30 of ISA-700 which would have enhanced transparency to the members of the Company.

f. Revaluation of fixed assets

Para 29 of IAS-16 states:

> *"….. Revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date."*

Para 32 of IAS-16 states:

> *"The frequency of revaluations depends upon the movements in the fair values of the items of property, plant and equipment being revalued. When the fair value of the revalued assets differs materially from its carrying amount, a further*

revaluation is necessary. Some items of property, plant and equipment may experience significant and volatile movements in fair value thus necessitating annual revaluations. Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant movements in fair value. Instead revaluation every three or five years may be sufficient."

i. The Company revalued its assets in 1995 and carried its land and building at revalued amounts, therefore, it should have arranged revaluation with sufficient regularity as required by IAS-16. However, the Company has also not disclosed any accounting policy regarding revaluation of fixed assets.

ii. It is also noted that the Company has carried land and building at revalued amount but the policy regarding tangible fixed assets states that the operating assets are recorded at cost less accumulated depreciation.

iii. The Auditors have raised the following qualification in audit report dated 6.03.2002 issued on the accounts of the company for the year ended 30.09.2001:

"Considering the huge losses on disposal of land and building, in our opinion there is a need for revaluation of assets to ensure that the assets are carried at their recoverable amounts and provision against impairment, if any is made accordingly"

The directors in their report dated 6.03.2002 stated the following:

"We agree with the view for revaluation of assets to ensure that the assets are carried at their realizable value in future."

Para 8 of IAS-36 states the following:

"An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset."

In this regard, no such revaluation was carried out by the company and the Auditors' subsequent years audit reports are silent on the said issue.

iv. Therefore, the correctness and valuation of "Surplus on Revaluation of Fixed Assets" amounting to Rs.99,522,333 had not been verified as reported in the aforesaid qualification. The total capital and liabilities of the Company as reported in the balance sheet as on 30.06.2005 amount to Rs.100,134,627. The said surplus accounts for 99.39% of the total capital and liabilities whose existence and valuation has not been verified and is material.

The aforesaid matters affect the trueness and fairness of the financial statements materially. The Auditors should have expressed adverse opinion in view of the above material issues.

g. In addition to the aforementioned matters, the erroneous mistake of giving incorrect financial year end by the Auditors in their Report was also highlighted in the SCN. However, the Auditors have not responded or spoken on the aforesaid issue.

13. The Auditors during the hearing on 13.09.2006 were asked for but could not submit copy of any correspondence with Company wherein they may possibly had asked the management of the Company

reasons for preparing the said accounts on going concern basis together with management assessment of Company's ability to continue as a going concern and its future plans for revival of the Company, as the Company has already ceased production activities since 24.06.1998 and has not reported any sales in the Accounts since year ended 2000. Auditors did not pursue to obtain evidence with regard to the accuracy of the management assertion that the Company is a going concern depending on the factors that have not materialized until now. The Auditors have however, expressed adverse opinion in subsequent accounts for the year ended 30.06.2006.

14. 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 and pervasive with regard to those accounts, they are required to issue an adverse opinion in their 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. The Auditors must realize their true role and restrain themselves from performing their duties indulgently.

15. 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, makes the auditors responsible in case they failed to make out a report in accordance with the legal requirements. It is, therefore, extremely important for the auditors to be vigilant and to perform their duties and obligation with due care while auditing the accounts and books of accounts.

16. It is clear from the above discussion that the Auditors had failed to perform their statutory obligations by not giving fullest information to the members and thereby not performing their professional duties with reasonable degree of care and skill. They knowingly and recklessly ignored their observations and gave an inappropriate bill of health to the Company's accounts.

17. For the reasons stated above, and taking a lenient view for this time and instead of imposing maximum penalty of Rs.100,000 (Rupees One hundred thousand) on each partner of the firm, I impose a fine of Rs.25,000 (Rupees twenty five thousand) each under Sub-section (1) of Section 260 of the Ordinance on all partners of M/s Gangat & Co., namely, Mr. Ahmed Adam Gangat (FCA) and Mr. Hasnain Abid Ali (ACA) for making report otherwise than in conformity with the requirements of Section 255 of the Ordinance on the Accounts of the Company for the year ended 30.06.2005.

18. The above referred partners of M/s Gangat & Co. are 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.

Ali Azeem Ikram
Director (Enforcement)

Announced:
May 25, 2007
ISLAMABAD

7th Floor, NIC Building, 63-Jinnah Avenue, Islamabad
Phones: 9207091-4, Fax: 9218592, E-mail: secphq@isb.paknet.com.pk