



Corporate Supervision Department
Company Law Division

Before Tahir Mahmood – Commissioner (Company Law Division)

In the matter of

**Karamat Chaudhry & Co., Chartered Accountants- Auditors of Express Oil (Private)
Limited**

Number and date of notice: EMD/242/L/799/2014-900 dated January 2, 2015
Date of hearing: April 8, 2015
Present: Mr. Karamat Ali Chaudhry

ORDER

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

This order shall dispose of the proceedings initiated against Karamat Chaudhry & Co., Chartered Accountants (the "respondent"), the auditor of Express Oil (Private) Limited (the "Company"). The proceedings against the respondent were initiated through show cause notice ("SCN") dated January 2, 2015 issued 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 examination of the annual audited financial statements for the years ended June 30 2011, 2012 and 2013 ("the Accounts") of the Company filed under Section 242 of the Ordinance revealed the following:

- i. Respective notes regarding 'Deferred Costs' for the years ended on June 30, 2011, 2012 and 2013 disclosed that since inception i.e. July 13, 2010, the Company had been capitalizing expenses that arise in the course of ordinary activities as 'Preliminary Expenses' and 'Pre-Commencement Expenses' and those were being categorized as Non-current Assets'; and
- ii. The management of the Company did not conduct a going-concern review despite the fact that the Company had not commenced its operation since inception i.e. July 13, 2010.

The respondent being statutory auditor of the Company for the years ended June 30, 2011, 2012 and 2013 issued audit reports on respective accounts to the members of the Company on September 22, 2011, September 26 2012 and September 26, 2013, respectively without any qualifications or modifications thereon.



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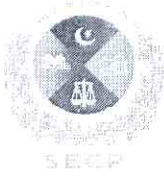
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3. In response to the Commission's queries in this regard, the respondent through letter dated December 22, 2014 submitted the following:

- i. *The company is an oil marketing company (OMC) duly licensed by Oil and Gas Regulatory Authority, Government of Pakistan. According to the terms and conditions of the license granted by OGRA, company cannot start its commercial activities until it develops its storage depots. Development of oil depot is a mega project and needs remarkable efforts, time and funds for construction. The company depots are under construction at Machike, district Sheikhpura;*
- ii. *Prior to the commercial activities all types of expenses are being clubbed in deferred cost. Subsequently, these are to be apportioned to fixed assets of the Company. Company is not deferring expenses that have arisen during ordinary / normal activities of the company. As these expenses have been incurred before commencing the commercial activities, therefore, have not been shown in Profit and Loss Account; and*
- iii. *The company is not facing any going concern issue. All your observations were taken care off and duly discussed with the management while issuing the report. Management is very enthusiastic about the project and intends to complete and start at any cost.*

Since the respondent's reply was not satisfactory, the SCN was issued for the alleged contraventions of the requirements of sub -section (3) of Section 255 of the Ordinance, on the following grounds:

- a) The respondent issued unmodified audit reports and opinions to the members of the Company for the years ended June 30, 2011, 2012 and 2013 despite the fact that the Company since inception has been categorizing expenses, which arise in the course of ordinary / normal activities and which also do not give any future economic benefits, as "Asset". Due to aforesaid incorrect classification, the Company's 'Non-current Assets' have been overstated while 'Expenses' have been understated. Consequently, the Company's Accounts do not give true and fair view for the respective years then ended.
- b) The respondent did not modify its audit report and opinion to the members of the Company for the year ended Jun 30, 2013 in respect of Company's ability to continue as a going concern despite the fact that the Company could not commence its operation despite elapse of almost three years since inception.



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4. In response to the SCN, the respondent submitted reply vide letter dated January 14, 2015 and made following submissions with regard to contents of the SCN:

- (i) Deferred costs being intangible, shown under non-current assets, is meant for development of property, plant and equipment. These costs have not been incurred for producing the trading items but to develop the property, plant and equipment, therefore, have not been shown in profit and loss account. Upon commencing commercial activities these costs are to be apportioned among items of Property, Plant and Equipment and expensed out through depreciation.
- (ii) As explained in earlier letter dated December 22, 2014, the Company is not facing any going concerns issues. All uncertainty factors were taken care of and duly discussed with management while issuing the report. Management is very enthusiastic about the project and intends to complete and start the project at any cost. In our best opinion, the Company is not facing any going concern issue.

A hearing in the matter was held on April 8, 2015. Mr. Karamat Ali Chaudhry, appeared before the undersigned and admitted that classifying expenses as 'Deferred Cost', was not correct accounting treatment applied by the Company and that being auditor of the Company the respondent should have modified the report/opinion appropriately. He further stated that the Company's Accounts for the year ended June 30, 2014 have been rectified by incorporating the appropriate accounting treatment. In respect of not modifying his report / opinion on the Company's Accounts for the year ended June 30, 2013 on going concern issue, he reiterated his earlier stance. He further submitted that the Company has access to finances and just because it has not commenced its commercial operations does not mean that it is not a going concern. Based on his submissions he requested for a lenient view in the matter.

5. Before proceeding further, it is necessary to advert to the following relevant provisions of Ordinance, International Standards on Auditing ("ISAs") and applicable Accounting and Financial Reporting Standards ("AFRS") for Medium-sized Entities ("MSEs"):



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Paras 9(a) and 11(b) of 'Framework' of AFRS, define "Assets" and "Expenses" in the following manner:

Para 9(a): "An 'asset' is a resource controlled by the entity as a result of past events and from which economic benefits are expected to flow to the entity."

Para 11(b): "Expenses are decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that results in decrease in equity, other than those relating to distributions to equity participants."

Para 1.6 of 'Section 1: Presentation of Financial Statements' of AFRS for MSEs provides as under:

"When preparing financial statements, management shall make an assessment of an ability to continue as a going concern. Financial statements shall be prepared on going concern basis unless management either intends to liquidate the entity or cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, those uncertainties shall be disclosed. When the financial statements are not prepared on a going concern basis, that fact shall be disclosed together with the basis on which the financial statements are prepared and the reason why the entity' is not considered to be a going concern. In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which shall be at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be reached without detailed analysis. In other cases, management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedule; and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate."

Paras 6, 17, 18, 19 and 20 of ISA 570, "Going Concern" states as under:

Responsibilities of the Auditor

Para 6. *The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. This responsibility exists even if the financial reporting*



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framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

Para 17. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for: (Ref: Para. A19)

- (a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or
- (b) In the case of a compliance framework, the financial statements not to be misleading.

Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists

Para 18. If the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

- (a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
- (b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business. (Ref: Para. A20)

Para 19. If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

- (a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and
- (b) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 18.5 (Ref: Para. A21–A22)

Para 20. If adequate disclosure is not made in the financial statements, the auditor shall express a qualified opinion or adverse opinion, as appropriate, in accordance with ISA 705.6 The auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern. (Ref: Para. A23–A24).

Para 6 of the ISA 705 states as under:

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)

7th Floor, NIC Building, 63-Jinnah Avenue
Islamabad, Pakistan

PABX: + 92-51-9207091-4, Fax: +92-51-9100454, 9100471, Email: webmaster@secp.gov.pk, Website: www.secp.gov.pk



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

The provision of sub-section (3) of section 255 of the Ordinance, inter alia, provides that *the auditor shall make a report to the members of the company on the accounts and books of accounts of the company and on every balance-sheet and profit and loss account or income and expenditure and on every other document forming part of the balance-sheet and profit and loss account or income and expenditure account, including notes, statements or schedules appended thereto, which are laid before the company in general meeting during his tenure of office.*

Section 260 of the Ordinance states as under:

"(1) 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 firm, shall, if the default is willful, be punishable with fine which may extend to one hundred thousand rupees.

(2) If the auditor's report to which sub-section (1) applies is made with the intent to profit such auditor or any other person or to put another person to a disadvantage or loss or for a material consideration, the auditor shall, in addition to the penalty provided by that sub-section, be punishable with imprisonment for a term which may extend to one year and with fine which may extend to one hundred thousand rupees."

6. I have analyzed the facts of the case, the relevant provisions of the Ordinance, requirements of AFRS and ISAs and the arguments put forth by the respondent. I have observed that as per requirements of the Ordinance, AFRS and ISAs quoted in the preceding paragraphs, the auditor was required to modify his report and opinion on the Accounts of the Company for the years ended June 30, 2011, 2012 and 2013, in view of the following:

- a) Expenses should be recognized in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. Matching concept under the applicable accounting framework does not allow the recognition in the balance sheet of the items which do not meet the definition of assets or liabilities. The Company cannot capitalize as an 'Asset' the expense, which arises in the course of ordinary / normal activities and which does not give any future economic benefits. Moreover, only those



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costs that are directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating can be capitalized. Since the expenses incurred by the Company in ordinary course of activities do not qualify the criteria, these should have been expensed out in the Profit and Loss Account / Income Statement as these were decrease in economic benefits and were not directly attributable costs. Despite the incorrect accounting treatment adopted by the Company, the auditor failed to modify its report on respective accounts.

- b) Due to incorrect treatment of treating expenses as deferred costs classified under 'Non-Current Assets', the Company's respective Accounts were materially misstated, because such expenses incorrectly classified under Deferred Costs constitute almost 25% of the total assets of the Company as of June 30, 2013.
- c) With regard to going concern assumption, the respondent has submitted that all certainty factors were taken care of and duly discussed with the management while issuing report on Accounts 2013 and that in his best opinion there were no doubts about Company's ability to continue as a going concern. The stance that the Company's oil depot was under construction and operations could only be commenced after its completion under OGRA's regulations, may appear to be mitigating factor, however, given the fact that the Company has been incurring losses owing to non-commencement of operations and the fact that no disclosure with regard to stage of completion of the project, management's assessment of going concern assumption and other related information have been made in the Accounts, the auditors, at least, should have given grounds based on which he assessed that there were no doubts about Company's ability to continue as a going concern and management's assessment in this regard was appropriate.

7. For the foregoing reasons, I am of the view that the provisions of section 260 of the Ordinance have been violated by the respondent. However, in view of admission of default by the respondent, his firm commitment to avoid such lapses in future and considering the statement that the Company's future Accounts will be rectified to reflect correct treatment, instead of imposing maximum penalty, I hereby impose a fine of Rs10,000/- (Rupees ten thousands only) on the respondent.



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The aforesaid fine must be deposited in the designated bank account maintained with MCB Bank Limited in the name of the "Securities and Exchange Commission of Pakistan" within thirty days from the receipt of this order and receipted bank vouchers must be furnished to the Commission. In case of non-deposit of the fine, proceedings for recovery of the fines as arrears of land revenue will be initiated.

Tahir Mahmood
Commissioner (Company Law Division)

Announced:
April 16, 2015
Islamabad