Before Tahir Mahmood – Commissioner (Company Law Division)

In the matter of

Rafiq & Co., Chartered Accountants - Auditor of Mount Fuji Textile Mills Limited

Number and date of notice:	EMD/242/K/630/2013-1604 dated August 27, 2014
Date of hearings:	November 19, 2014 and June 23, 2015
Present:	Mr. Mahmood Rafi, the Authorized Representative

ORDER

UNDER SECTION 260 READ WITH SECTIONS 255 AND 476 OF THE COMPANIES ORDINANCE, 1984

This order shall dispose of the proceedings initiated against Rafiq & Co., Chartered Accountants, (the "respondent") the statutory auditor of Mount Fuji Textile Mills Limited (the "Company") for the year ended June 30, 2012. The proceedings were initiated through show cause notice ("SCN") dated August 27, 2014 issued under the provisions of section 260 read with sections 255 and 476 of the Companies Ordinance 1984 (the "Ordinance").

2. The brief facts of the case are that examination of annual audited financial statements ("Accounts") of the Company for the year ended June 30, 2012 submitted with the Commission in pursuance of section 242 of the Ordinance revealed that the Company had accounted for investments amounting to Rs222.473 million (2011: Rs209.526 million) in shares of quoted companies at cost (*Reference note 4 to the Accounts*). The treatment was not in accordance with the requirements of Accounting and Financial Reporting Standards ("AFRS") applicable to Medium Sized Entities ("MSEs") which require such investments to be carried at fair value. The Company did not disclose its policy regarding investment in quoted shares under "Significant Accounting Policies" forming part of the notes to the Accounts.

3. The financial impact of the aforementioned contravention with the requirement of AFRS by the Company appeared to be material. However, the respondent, who audited the Accounts of the Company, did not modify the audit report and opinion on the Accounts for the year ended June 30, 2012 to highlight the aforesaid non-compliances by the Company and its financial impact on the Accounts. Hence the audit report on the Accounts was, prima facie, not in accordance with

the requirements of section 255 of the Ordinance and International Standards on Auditing ("ISA") as the respondent failed to bring out material facts about the affairs of the Company by:

(a) not reporting on the non-disclosure of the *accounting policies* and method adopted, including the criteria for recognition and the basis of measurement applied for each class of *investment* in violation of applicable AFRS; and

(b) not modifying audit report to the members of the Company despite the fact that the Company had not stated the investments in quoted shares at fair value and, therefore, had not accounted for the loss from investment of Rs70.85 million during the year ended June 30, 2012, in violation of applicable AFRS that resulted in misstatement of Accounts of the Company.

Consequently, the SCN was issued to the respondent under section 260 read with sections 255 and 476 of the Ordinance.

4. In response to the SCN, the respondent submitted reply vide letter dated September 6, 2014. A brief of the submissions in respect of the contents of the SCN is as under:

> *"We wish to state that the non-conformity with the requirements of the law was not willful and was an act of omission which is deeply regretted. The omission has been duly corrected in our subsequent report for the year ended June 30, 2013. We, therefore, request you that since this is the first omission as regards this company's Accounts, it may kindly be condoned."*

The case was fixed for hearing on November 19, 2014 and on behalf of the respondent Mr. Mahmood Rafi appeared before the Head of Department, Corporate Supervision Department *(previously Enforcement Department)*, who was the authorized adjudicating officer at that time. Mr. Rafi accepted the default and requested to take a lenient view. Subsequently, due to revision in delegation of powers of the Commission, the respondent was provided another opportunity of hearing. The respondent opted for rehearing of the case and was again represented by Mr. Mahmood Rafi in hearing before the undersigned on June 23, 2015. He mainly reiterated the earlier written submissions and requested for a lenient view on the grounds that the non-conformity with requirements of the law was due to an inadvertent omission and was not willful. He further reiterated that the omission had been rectified in the next year's accounts of the Company.

5. Before proceeding further, it is necessary to advert to the following relevant provisions of Ordinance, AFRS and ISA.

Section 16 ***'Investments'*** of Accounting and Financial Reporting Standards ("AFRS") applicable on MSEs states as under:

'Subsequent Measurement of Investment'

> *"16.3 After initial recognition, an entity shall measure investments at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following investments:*
> *(a) held-to-maturity investments, which shall be measured at amortised cost using the effective interest method; and*
> *(b) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured, which shall be measured at cost."*

'Gains and Losses'

> *"16.9 A gain or loss arising from a change in the fair value of an investment shall be recognised as follows.*
> *(a) A gain or loss on an investment classified as at fair value through profit or loss shall be recognised in profit or loss."*
> *(b) A gain or loss on an available-for-sale investment shall be recognized directly in equity, through the statement of changes in equity, except for impairment losses and foreign exchange gains or losses, until the investment is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss. However, interest calculated using the effective interest method is recognised in profit or loss.*

Para A2 and A3 of *'Application and Other Explanatory Material'* to the International Standard on Auditing 705 *"Modifications to the Opinion in the Independent Auditor's Report"* (*"ISA 705"*) states as under:

> **A2.** *ISA 700 requires the auditor, in order to form an opinion on the financial statements, to conclude as to whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. This conclusion takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements in accordance with ISA 450.5*

> **A3.** *ISA 450 defines a misstatement as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Accordingly, a material misstatement of the financial statements may arise in relation to:*
> *(a) The appropriateness of the selected accounting policies;*
> *(b) The application of the selected accounting policies; or*
> *(c) The appropriateness or adequacy of disclosures in the financial statements.*

Para 4 of *ISA 705* states as under:

> *The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:*
>
> *(a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or*
> *(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.*

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)*

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

Section 255 of the Ordinance prescribes powers and duties of the auditors and sub-section (3) specifically prescribes the mandatory contents of the audit report.

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 wilful, 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 ISA and the arguments put forth by the respondent. I have observed

that as per requirements of the Ordinance, AFRS and ISA quoted in the preceding paragraphs, the respondent being auditor of the Company was required to modify its report and opinion on the Accounts of the Company for the year ended June 30, 2012, in view of the following:

a) The Company failed to disclose its policy regarding investment in quoted shares under 'Significant Accounting Policies', forming part of the notes to the Accounts.

b) The Company failed to comply with requirements of AFRS as it had accounted for investments amounting to Rs222.473 million (2011: Rs209.526 million) in shares of quoted companies at cost instead of fair value, in contravention with the requirements of Para 16 of AFRS applicable to MSEs.

c) As a result of aforesaid contravention with applicable AFRS, the loss amounting to Rs70.85 million was not accounted for, causing misstatement in the Accounts.

d) The aforesaid non-compliance with requirements of AFRS had material impact on the Accounts of the Company due to following factors:

    i. Correct accounting treatment in line with requirements of AFRS was not adopted.

    ii. An amount equal to Rs70.85 million being loss on investments that were required to be carried at fair value was not recognized in profit & loss account or equity causing misstatement in the respective heads.

    iii. The amount of misstatement is 8.06% of the sales, 5.39% of total assets and 16.78% of the unadjusted equity (net assets) and, therefore, has material impact.

Despite the aforesaid contraventions with applicable AFRS by the Company, the respondent failed to modify its audit report on the Accounts and issued an unmodified report to the members. Moreover, in respect of the respondents' submission regarding rectification of default in the subsequent Accounts for the years ended June 30, 2013 and June 30, 2014, I have observed that the Company has classified the investments in quoted shares as "available for sale" and has stated them at fair value. The resultant loss due to change in fair value has been recognized under the equity as per requirements of the AFRS. However, despite material decrease in price of quoted shares, the Company has not recognized the impairment losses in the profit and loss accounts against the requirements of section 16 of AFRS. Moreover, while restating the figures of investment in quoted shares to apply the requirements of AFRS in Accounts for the year ended June 30, 2013 and June 30, 2014, the Company has not meticulously followed the requirements of section 12 of the AFRS: *Accounting Policies, Changes in Accounting Estimates and Errors*. It has failed to apply the corrections retrospectively in respect of all the relevant reported figures and proper disclosures have not been made. The auditor has again given an unmodified report on Accounts for the years ended June 30, 2013 and 2014.

7. I deem it necessary to make some observations on the role of auditor of a company. The duties and responsibilities of an auditor appointed by the shareholders under the law 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. They elect directors and entrust the affairs of the company to them in the hope that they will manage the company to shareholders' benefits. There is no such arrangement in place whereby the shareholders can have an independent view as to how the directors have managed the affairs of the company. The financial statements are the most important source of reliable information for the shareholders who make their investment decision based on such information. The financial statements not only show the financial position and performance of the company but also show the results of management's stewardship of resources entrusted to it. Therefore, correct reporting in the financial statements in line with applicable financial reporting framework is of utmost importance. The law, therefore, recognizing this situation, has provided for the appointment of auditors who shall be responsible to audit the books of account, documents and financial statements required by the law and make out a report on them at the end of each year. This being the only safeguard provided by law to the shareholders to ensure accountability of the management, put the auditors to a high level of accountability in case they fail to make out a report in accordance with the legal requirements. For these reasons, it is of utmost importance for the auditors to exercise due care and diligence in performing their duties and discharging their responsibilities and maintain a high level of trust and integrity at their end.

8. For the foregoing reasons, I am of the view that the respondent failed to bring out the material misstatement apparent on the very face of the Accounts and, therefore, is liable to penalty under section 260 of the Ordinance. Accordingly, I hereby impose a fine of Rs10,000/- (Rupees ten thousand only) under sub- section (1) of section 260 of the Ordinance on the respondent.

The respondent is directed to deposit the aforesaid fine in the designated bank account maintained in the name of Securities and Exchange Commission of Pakistan with MCB Bank Limited within thirty days from the receipt of this Order and furnish receipted vouchers for information and record, failing which proceedings under the Land Revenue Act, 1967 will be initiated which may result in the attachment and sale of movable and immovable property.

Tahir Mahmood
Commissioner (Company Law Division)

Announced:
July 6, 2015
Islamabad