Before Mr. Abid Hussain, Executive Director

In the matter of

Qadeer and Co., Chartered Accountants- Auditors of Chaudhri Wires (Private) Limited

Number and date of show cause notice	CSD/ARN/307/2016 dated August 09, 2016
Date of Hearing	October 17, 2016
Present	Mr. Abdul Rahman, Manager Audit, on behalf of Qadeer and Co., Chartered Accountants

ORDER

Under Section 260 read with Section 476 of the Companies Ordinance, 1984

This order will dispose of the proceedings initiated against Mr. Nawaz Khan, FCA, audit engagement partner of Qadeer and Co., Chartered Accountants (the respondent), in respect of the audit of annual financial statements (the "accounts") of Chaudhri Wires (Private) Limited ("the Company") for year ended June 30, 2014 and June 30, 2015. The proceedings were initiated through show cause notice dated August 09, 2016 under provisions of Section 260 read with Section 255 and 476 of the Companies Ordinance, 1984 ("the Ordinance").

2. The brief facts of the case enumerate from examination of accounts of the Company for years 2014 and 2015 transpired that the Company had ceased its operations and reported nil sales since 2013. The Company, in its notes to the accounts for the aforesaid years, merely stated that although it has plans to continue operations however negotiations with new customers have not materialized.

3. It was also noted that the Company was not charging depreciation on operating fixed assets amounting to Rs. 235.158 million of the Company as per note 6 to the accounts the Company. Meanwhile, the accounting policy for fixed assets and depreciation disclosed in note 2.03 to the accounts stated that the fixed assets were stated at written down value except land which is stated at cost. It is also stated that

depreciation is charged on assets from the year in which these are used for productions whereas no depreciation is charged for the year in which the asset is disposed of.

4. Further, the Company in its notes to the accounts stated that the financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan and the requirements of the Ordinance. Approved accounting standards comprise of Accounting and Financial Reporting Standards (AFRS) for small-sized entities (SSE) as notified under the provision of the Ordinance.

5. The aforesaid reflected that the Company, misstated profit by not charging depreciation, the policy for depreciation was in contravention to AFRS-SSEs, inadequately disclosed pervasive conditions of material uncertainty to continue as going concern and inappropriately using going concern assumption. This tantamount to misstatement by Company that the underlying accounts for year 2014 and 2015 were prepared in accordance with AFRS-SSE.

6. The respondent, being statutory auditor of the Company for years 2014 and 2015, was required to either express adverse or qualified opinion in accordance with the ISA 705 and 570 owing to misstated and misleading financial statements. However, the respondents, in their audit report to the shareholders for years 2014 and 2015 merely gave emphasis of matter regarding going concern as:

"Without qualifying our opinion, we draw attention to Note 2.02 in the financial statements which indicate that the Company has ceased its operations and discharged its liabilities. Though the management has plans to continue the operations of the Company and is in the process of negotiating with new customers for the future business but these plans have not yet been materialized. These conditions indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern."

7. In view of the above, *prima facie*, the auditor failed to bring out material facts about the affairs of the company. The respondent in the audit reports, on the accounts of the Company for years 2014 and 2015, failed to express a qualified or adverse opinion in accordance with the International Standards on Auditing ("ISA") i.e. ISA 705 and 570.

8. Keeping in view the facts enumerated above, a show cause notice under Section 260 read with Section 255 and 476 of the Ordinance dated August 09, 2016 was issued to the respondents, advising them to

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show cause within 14 days of the date of the notice as why penal action may not be taken against them for failing to perform the audit of financial statements as per requirement of the Ordinance and relevant ISAs and make a report to the shareholders in accordance thereof.

9. The respondent in its reply to said show cause vide letter dated August 25, 2016, stated that:

i. The Company in its note 2.03 of the accounts has stated that fixed assets are stated at written down value except land which are stated at cost. This relates to presentation of fixed assets in the financial statements. Thus the Company adopts the policy of presenting fixed assets value which is written down after deduction of total depreciation from cost/ revalued amount except land.

ii. The Company in its note 2.03 of the accounts has stated that depreciation is charged on assets from the year in which these are used for production whereas no depreciation is charged for the year in which the asset is disposed off. Only this relates to depreciation method which describes that charging of depreciation is based on the production of the Company (i.e. usage method) and it is not stated elsewhere that the Company is charging depreciation on the basis of reducing balance method. As there were no production during the two years mentioned so no depreciation was charged in the financial statements.

iii. As for inappropriateness of going concern assumption, para 25 of International Accounting Standard (IAS)-1 is referred that states that '*an entity shall prepare financial statements on a going concern basis unless management wither intends to liquidate the entity or to cease trading or has no realistic alternative but to do so*'. Reference is drawn from note 2.02 to the accounts that reflects that the Company has no intention of liquidating the Company or ceasing the operations. The Company has no material liabilities which force the Company to liquidate or cease trading. As total assets of the Company stood at Rs. 243.908 million whereas liabilities are only 0.285 million for year 2015.

iv. The evidences produced by the Company including their future business plans, correspondence with parties, financial strength of directors endorsed their intention as disclosed in financial statements.

v. All sufficient and appropriate evidences made us to believe that the Company is going concern and the financial statements should be prepared on going concern basis although a material uncertainty exists. This uncertainty was properly disclosed in financial statements and highlighted and drew attention to said disclosure in accordance with Para 18 and 19 of ISA 570.

vi. It may be considered that it is a small sized company with significant financial liability and its users are only the members of the Company. No member/ director had raised any doubt or confusion on these two treatments in the financial statements and duly signed and approved these financial statements.

10. An opportunity of hearing in the matter was provided to the respondents of the said show cause notice on October 17, 2016. Accordingly, Mr. Abdul Rahman, authorized representative of the respondent appeared on the said hearing date on behalf of the respondent. The authorized representative initially reiterated the stance taken earlier in its written reply to said show cause notice. However, on query regarding appropriate policy and requirement of charging depreciation as per AFRS-SSE, it was admitted that the Company had indeed defaulted to comply with the aforesaid legal requirements by not charging depreciation thereby directly impacting profits. The authorized representative was also asked to clarified what evidence was reviewed to establish intention of Company to continue operation, sufficient audit evidence to verify appropriateness of business plan in 2014, addition audit procedures in view of persistent material uncertainty in year 2015 and third party confirmation. It was contended that the respondent during audit reviewed the email correspondence and draft agreements however failed to cross verify it as realistic or viable nor obtained any third party confirmations. Moreover, no response was given as to the audit procedures adopted in year 2015 despite persistent uncertainty faced by Company as in 2014. The authorized representative admittance default and assured future compliance with relevant legal requirements and ISAs.

11. In terms of notification S.R.O 1003(I)/2015 dated October 15, 2015 the power to adjudicated cases under Section 260 of the Ordinance has been delegated to Executive Director (Corporate Supervision Department).

12. Before elaborating the facts of the case, I would quote relevant paras of AFRS-SSEs, ISAs and Ordinance is given below:

<u>AFRS-SSE</u>

Para 3.33 : *Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases the date when the asset is derecognised. <u>Therefore, depreciation does not cease when the</u>*

asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

Para 37 states:
"The depreciable amount (cost less expected proceeds from disposal) of an item of property plant or equipment shall be allocated on a systematic basis over its useful life. Straight line depreciation is the simplest method."

Para 40 states:
"The financial statements shall disclosed for each class of property, plant and equipment a reconciliation of the carrying amount at the beginning and end of the period showing:

a) Additions
b) Disposal
c) Depreciation: and
d) Other movement

ISA 570- Going concern

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 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 9:
The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;
(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
(c) To determine the implications for the auditor's report.

Para 12:
The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. (Ref: Para. A7–A9, A11–A12)

Para 16
If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors.

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.

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.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 21:

If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the auditor shall express an adverse opinion. (Ref: Para. A25–A26)

<u>ISA 705- Modification to the opinion in the Independent Auditor's report</u>

Para 6:

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)

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Section 255 of the Ordinance prescribes powers and duties of the auditors, the manner, requirements and contents of auditors' report on the accounts. Rule 17 (A) of the Companies (General Provisions and Forms) Rules, 1985 requires that auditor's report shall be on prescribed format contained in Form 35-A.
Section 260 of the Ordinance states that,

"*(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 [1][one year] and with fine which may extend to [2][one hundred] thousand rupees."

13. I have gone through the requirements of law, explanation provided by the Company and facts placed before me by the Department. In the order of incidence of events, I have observed the following:

a) The Company had ceased its operations and reported nil sales since 2013.
b) The Company, in its note 2.02 to the accounts for the years 2014 and 2015 stated that although it has plans to continue operations however negotiations with new customers have not materialized. This in itself is enough to establish conditions of material uncertainty faced by the Company.
c) Despite persuasive conditions of material uncertainty that continued to exist in year 2015 (as in 2014), the Company however continued to prepare its financial statements on going concern assumption.
d) The Company has stated policy for recognizing fixed asset on written down value and that depreciation is charged when assets in production whereas no depreciation for the year when the asset is disposed of. Plain reading of para 3.3 (relevant phrase underlined) and para 37 of AFRS-SSE is sufficient to stablish that aforesaid policy of depreciation was in contravention to AFRS-SSEs.
e) Reconciliation of depreciation was not provided on face of financial statements in contravention to AFRS-SSE.

f) The Company, by not charging depreciation assets amounting to Rs. 235 million, misstated the profits thereby rendering underlying financial statements as misleading.

g) In view of misstatement by the Company regarding compliance with AFRS-SSE, non-charging of depreciation, inadequate disclosure regarding material uncertainty and inappropriate use of going concern assumption, the respondent being statutory auditor of the Company was required to either express adverse or qualified opinion in accordance with the ISA 705 and 570.

h) Instead, respondent in his report for year 2014 merely added an emphasis of matter paragraph referring to managements disclosure in note 2.02 to the accounts. Moreover, despite persistence of said event, audit report for year 2015, failed to express qualified or adverse opinion in accordance with the ISA 705 and 570.

i) The respondent based his opinion on a flawed judgement that assets in excess of liabilities, thereby the possibility of liquidation of assets to pay off liabilities did not exist and that none of the directors had any objection on policy adopted for depreciation and going concern. While size and nature of liabilities are one of the methods, not entirely exclusive, to determine presence of material uncertainty however complete reliance on director's judgement, keeping all other factors aside, is against the spirit and purpose of independent audit of financial statements.

j) The respondent failed to demonstrate in its submission, evidence of adopting appropriate audit procedures (in presence of ceasing of trading) or additional audit procedures (persistent of same conditions in 2015) for conducting audit, failed to determine viability of management plans/ negotiations thereby failed to make appropriate opinion in audit report.

k) The respondents failed to perform the audit of the financial statements of the Company as per the requirements of Section 255 of the Companies Ordinance, 1984 and relevant ISAs and make a report to the shareholders in accordance thereof.

14. The Company had in fact itself disclosed that its operations were closed and its negotiations with new customers, if any, were not materialized. This in itself is enough to establish conditions of uncertainty faced by the Company to continue as going concern. Also persistent presence of the same uncertain conditions i.e. in 2014 and 2015, is a fitting alert for an auditor to raise red flag about the decision of the Company to prepare its accounts on going concern assumption. Fixed assets are the most pertinent aspect of balance sheet of any Company. Therein, not charging depreciation and not reconciling depreciation by Company is another default, impacting profits to the extent of rendering underlying financial statement as

misleading, was in itself prominent and pertinent enough for an auditor to detect, qualify their opinion and report to the shareholders. The respondent however failed at detecting, verifying and concluding appropriately on all the factors above. Rather the respondent, apparently, based his opinion solely on a flawed assumption that no material liabilities are present that force the company to liquidate or cease business. This tantamount to respondent not performing audit as per the legal requirements and relevant ISAs, not modifying opinion appropriately and thereby failing to bring out material facts of the affairs of the Company in his report to shareholders. The debate on audit procedures adopted by respondent is futile as the respondent have failed to present or contend that management's future plan, if any, were carefully analyzed and admitted that its appropriateness was not judged by the respondent and that too for two consecutive years. This is itself enough to establish negligence of the respondents in performing duties as auditor of the Company.

15. A statutory auditor is bound to follow the requirements of the Ordinance, relevant Rules, ISAs and express an opinion using professional judgement and maintaining professional skepticism. Further auditor is required to identify and assess risks of material misstatements, obtain sufficient appropriate audit evidence and form an opinion based on conclusion drawn from such evidence. Also, in specific context of auditor's responsibilities in the audit of financial statements relating to management's use of the going concern assumption in the preparation of the financial statements, ISA 570 is very vocal and clear. This includes obtaining sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, to conclude whether a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and to determine the implications for the auditor's report. Also, indicative conditions are also given that impact the ability of a company to continue as going concern. The duties and responsibilities of an auditor appointed by the shareholders under the law speaks of a watchman through which the shareholders seek an independent view as to how the directors have managed the affairs of the company. Also, audit of financial statements, being the foremost source of information for current and prospective investors, places auditor at a higher level of accountability and transparency. Therein the auditor is required to exercise due care and diligence in performing their duties and discharging their responsibility and maintain the trust and integrity.

16. For the foregoing reasons, I am of the view that the respondents in their audit reports for year 2014 and 2015 failed to appropriately modify his opinion and hence has not discharged his duties under the law. However, keeping in view the admittance of default, assured future compliance and the fact that the Company is a private company, I hereby conclude the proceedings with a stern warning to the respondents to be careful in future and ensure compliance of law in its true letter and spirit.

Abid Hussain
Executive Director
Corporate Supervision Department

Announced:
November 01, 2016