



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN

Adjudication Department-I Adjudication Division

Before

Shahzad Afzal Khan, Director/ Head of Department

In the matter of

Khairpur Sugar Mills Limited

Show Cause Notice No. & Date CSD/ARN/284/2016-353 dated June 25, 2024

Date of Hearing: August 09, 2024

Authorized Representative: Mr. Muhammad Farooq, ACA-Partner; and
Mr. Ali Lakhany, Reanda Haroon Zakaria
& Co. Chartered Accountants

ORDER

Under Section 512(2) of the Companies Act, 2017 read with Regulations 36(3) & 37 of the Listed Companies (Code of Corporate Governance) Regulations, 2019 and Regulations 6(i) & 7 of the Auditors (Reporting Obligations) Regulations, 2018

This Order shall dispose of the proceedings initiated by the Securities and Exchange Commission of Pakistan (the Commission) through Show Cause Notice dated June 25, 2024 (the SCN) issued under section 512(2) of the Companies Act, 2017 (the Act) read with regulations 36(3) & 37 of the Listed Companies (Code of Corporate Governance) Regulations, 2019 (the Regulations) and regulations 6(i) & 7 of the Auditors (Reporting Obligations) Regulations, 2018 (the Reporting Regulations) to Mr. Muhammad Farooq, ACA-Partner, Reanda Haroon Zakaria & Co. Chartered Accountants (the Auditor), auditor of Khairpur Sugar Mills Limited (the Company).

2. Brief facts of the case are that:

(i) During the review of the annual audited financial statements of the Company for the financial year ended September 30, 2022 (the Accounts), it was transpired that the Company elected following independent directors in its Extraordinary General Meeting held on April 21, 2021 (the EOGM), whose names were not in the Pakistan Institute of Corporate Governance (PICG) database of independent directors, contrary to the requirement of section 166(1) of the Act:

- a. Mr. Asif Khan Brohi; and
- b. Lt. Gen (Retd) Tahir Mahmud Qazi



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- (ii) The aforementioned directors were also members of the audit committee, and Mr. Brohi was also the Chairman of the audit committee, contrary to the requirements of regulation 27(1)(i) & (ii) of the Regulations. However, in its Statement of Compliance (SOC) with the Regulations for the years 2021 and 2022, the Company expressed at Sr. No. 18 that it had complied with all the mandatory requirements of the Regulations.
- (iii) The Auditor of the Company failed to disclose the aforementioned non-compliances of the Company in its review report on Company's SOC with the Regulations for the years ended September 30, 2021, and September 30, 2022.
- (iv) The Commission vide letter dated May 31, 2023, asked the Auditor to provide his comments on the aforesaid non-compliances of the Company and for not highlighting the said non-compliances in its review report for the years 2021 and 2022. The Auditor, vide letter dated June 07, 2023, provided his reply and, *inter alia*, stated that
- 1) *"We understand that Regulation-6(3) of the Regulations refers to sub-section 2 of Section 166 of the Act;*
 - 2) *Reg-6(3) requires an independent director to submit a declaration about criteria of independent to the Chairman of the board at first meeting after the elections;*
 - 3) *Our scope of review is to check whether the declaration was submitted to the Chairman of the Board;*
 - 4) *We understand that sub-section 1 of Section 166 is not subject to scope of Reg-6(3);*
 - 5) *We understand that Reg-6(3) and 166(2) is fully complied and required no modification in review report."*
- (v) The auditors review report is issued under Auditors (Reporting Obligations) Regulations, 2018 (**the Reporting Regulations**) which require auditors to specifically report that:
- a) *Auditor's responsibility is to review whether the Statement of Compliance reflects the status of the Company's compliance with the provisions of the regulations;*
 - b) *Highlight any non-compliance with the requirements of the Regulations;*
 - c) *Inquires of the Company's personnel and review of various documents prepared by the Company to comply with the Regulations;*
 - d) *As a part of audit of the financial statements, auditors are required to obtain an understanding of the accounting and internal control systems*
- (vi) The Company was required to disclose any non-compliance with the mandatory regulations as required under regulation 36(1) of the Regulations. However, the Company in its SOC stated that it has complied with all the requirements of mandatory Regulations (3,6,7,8, 27, 32 and 36) whereas, the Company was not compliant with the provisions of regulations 6, 27 & 36 of the Regulations for the years 2021 and 2022.
- (vii) The Company, in its SOC with the Regulations for the year ended September 30, 2023, removed its compliance status at Sr. No. 18 with regulation 6 of the Regulations and also explained the nature of the non-compliance. Further, the Auditor has also modified its review report on SOC for the year 2023. The Auditor had stated in its review reports for the years 2021 and 2022 that the Company was compliant with the requirements of the



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Regulations in spite of the fact that the Company was non-compliant with the same Regulations for the said years.

(viii) It appears from the aforesaid, that the Auditor failed to highlight the Company's non-compliances with regulation 6, 27 & 36 of the Regulations for the years 2021 and 2022, thus, *prima facie*, contravened the provisions of regulation 36(3) of the Regulations and regulation 6(i) of the Reporting Regulations.

3. In order to take cognizance of the aforesaid contraventions, the SCN was served upon the Auditor seeking justification for the aforesaid violations. The Auditor vide letter dated July 04, 2024, *inter-alia*, submitted that:

"1. For years 2021 and 2022, our interpretation and understanding remains consistent with our response provided earlier to letter No. EMD/233/340/2002/511 dated May 31, 2023, and is reproduced below:

a) We understand that relevant regulation 6(3) of the Listed Companies (Code of Corporate Governance) Regulations, 2019 (the "Regulations") refers to sub section 2 of section 166 of the Companies Act, 2017 (the "Act") which deals with the criteria of independence.

b) Regulation 6(3) of the Regulations requires an independent director to submit a declaration about criteria of independence to the chairman of the Board at the first meeting after the election of directors. Our scope of review is to check whether the declaration was submitted to the Chairman of the Board under this regulation

c) We understand that the requirement of sub section 1 of section 166 of the Act is not subject to the scope of regulation 6(3) of the Regulations.

d) We understand that regulation 6(3) of the Regulations read with subsection 2 of section 166 is fully complied with by the Company and attracts no modification in our review report.

2. In the year ended September 30, 2023, the Company itself highlighted its non-compliance with section 166(1) of the Companies Act 2017 along with its explanation to rectify it in next board of directors' election in 2024. This had to be highlighted in our review report to ensure compliance with the Annexure VI of the Auditors (Reporting Obligations) Regulations, 2018 (the "Reporting Regulations") which requires auditors to highlight the matters in their review report which are highlighted and explained by management itself in their Statement of Compliance as non-compliance. Therefore, for the year 2023 as an auditor, we were obligated to highlight the matter in the review report in accordance with the said Reporting Regulations because the management itself had reported non-compliance irrespective of our interpretation and understanding.

3. We believe, based on the above submission, that the auditor has not contravened the provisions of regulations 36 (3) of the Regulations and regulation 6(i) of the Reporting Regulations for the year 2021 and 2022 and respectfully request you to kindly adopt a lenient stance on this matter



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and to consider its disposal favorably. It is also pertinent to mention here that the Company has subsequently made full compliance with the requirements of section 166(1) of the Act."

4. In order to provide opportunity of personal representation, hearing in the matter was fixed for August 09, 2024 wherein Mr. Muhammad Farooq, ACA-Partner; and Mr. Ali Lakhany, Reanda Haroon Zakaria & Co. Chartered Accountants appeared and stated:

- Written response vide letter dated July 04, 2024 is reiterated;
- Regulation 6(3) of the Regulations mandates the requirement of declaration by independent directors;
- Responsibility of the Auditor is to check the submission of declaration by the independent director;
- Review report is based on the documents provided by the Company;
- As per Annex-VI of the Reporting Regulations, if the Company itself points out the non-compliance than it is the responsibility of the Auditor to point out the same in his review report; and
- Assured to improve the checklist.

5. Relevant provisions of the Regulations, Reporting Regulations and the Act are reproduced as under:

"The Regulations and Reporting Regulations:

Regulation 36(3) of the Regulations:

36. Compliance Statement and Auditor Review. -

(3) It is mandatory that the statutory auditors of company shall highlight any noncompliance with these Regulations in their review report.

Regulation 6(i) of the Reporting Regulations:

6. Auditor's review report on the statements of compliance with corporate governance regulations. - The auditor of a company shall make out review report, where applicable, to the members on the statement of compliance with corporate governance regulations on the formats....

Regulation 37 of the Regulations:

37. Penalty. - Whoever fails or refused to comply with, or contravenes regulation 3, 6, 7, 8, 27, 32, 33 and 36 of these Regulations, shall be punishable with penalty as provided under sub-section (2) of section 512 of the Act.

Regulation 7 of the Reporting Regulations:

7. Penalty. - The Commission may, in case of contravention of any requirement of these Regulations, impose a penalty as provided under sub-section (2) of section 512 of the Act.

The Act:

Section 512 of the Act:

512. Power to make regulations. -(1) The Commission may, by notification in the official Gazette, make such regulations as may be necessary to carry out the purposes of this Act: Provided that the power to make regulations conferred by this section shall be subject to the condition of



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previous publication and before making any regulations the draft thereof shall be published in the manner considered most appropriate by the Commission for eliciting public opinion thereon within a period of not less than fourteen days from the date of publication.

(2) Any regulation made under sub-section (1) may provide that a contravention thereof shall be punishable with a penalty which may extend to five million rupees and, where the contravention is a continuing one, with a further penalty which may extend to one hundred thousand rupees for every day after the first during which such contravention continues."

6. I have gone through the facts of the case, considered both the written and verbal submissions submitted by the Auditor in the light of the applicable legal provisions and available record before me. At this juncture, it is imperative to address the following:

(i) The Auditor's interpretation of the scope of responsibilities under the Regulations:

The Auditor's argument is based on the interpretation that regulation 6(3) of the Regulations is exclusively read with section 166(2) of the Act, focusing primarily on the declaration of independence that must be submitted to the Chairman of the Board. Consequently, the Auditor focused solely on verifying the submission of this declaration and interpreted his responsibility as limited to ensuring compliance with the same.

However, regulation 6(3) of the Regulations explicitly mandates that *"It is mandatory that the independent director shall submit his consent to act as director, along with a declaration to the company that he qualifies the criteria of independence notified under the Act, and such declaration shall be submitted to the chairman of the Board at the first meeting..."*

It is pertinent to note that regulation 6(3) of the Regulations relates not only to section 166(2) of the Act but also to section 166(1) of the Act which requires that independent directors must be selected from the PICG database. Compliance with section 166(1) of the Act is a prerequisite for fulfilling the independence criteria under section 166(2) of the Act.

Furthermore, under International Standard on Auditing (ISA) 720 (Revised) - The Auditor's Responsibilities Relating to Other Information, the auditor is required to consider information included in the annual report that is not part of the financial statements. The auditor must read and assess whether this other information is materially inconsistent with the financial statements or otherwise misleading.

Moreover, the Auditor in his review report also included a statement that *"our responsibility is to review whether the Statement of Compliance reflects the status of the Company's compliance with the provisions of the Regulations and to report if it does not and to highlight any non-compliance with the requirements of the Regulations"*.

Therefore, the Auditor's duty under regulation 36(3) of the Regulations is broader, requiring him to highlight any non-compliance with the Regulations, including



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compliance with section 166(1) of the Act related to registration with PICG database of independent directors. The failure to report such non-compliance indicates a lapse in fulfilling the comprehensive regulatory responsibilities.

- (ii) **Whether the Auditor's failure to report the non-compliance in the years 2021 and 2022 constitutes a violation?**

Yes, regulation 36(3) of the Regulations mandates reporting of non-compliance and regulation 6(i) of the Reporting Regulations requires a comprehensive review of compliance, the Auditor's omission to report the non-compliance constitutes violation of these regulations. The fact that the Company later acknowledged the non-compliance in its SOC for the year 2023 further emphasizes that this issue should have been identified and reported earlier.

- (iii) **Whether the Auditor's reliance on the Company's statements and documentation adequately justifies his failure to highlight non-compliance regarding the independence of the directors in their review report?**

No, the Auditor's duty to report non-compliance with independence requirements as stipulated under the Act and the Regulations remains paramount. While the Auditor may rely on the Company's assertions and documentary evidence to some extent, he is expected to conduct sufficient independent inquiry to verify the accuracy of such assertions and placing reliance solely on information provided by the Company without conducting its own assessment and verification cannot be considered appropriate grounds for non-compliance.

Auditors play a crucial role in providing assurance to stakeholders, including investors, about the accuracy and reliability of financial and governance-related disclosures, therefore, highlighting non-compliance with independence is crucial for maintaining investor confidence and ensuring transparency in corporate governance.

- (iv) **Whether the assertion that the auditor's obligation to highlight non-compliance in the review report, is contingent upon the Company's disclosure of non-compliance in SOC?**

No, the Auditor's obligation to highlight non-compliance in review report, as per Annexure VI of the Reporting Regulations, is not contingent upon the Company's disclosure of non-compliance in SOC. Regulation 6(i) read with Annexure VI of the Reporting Regulations outlines the Auditor's duty to independently assess and report any non-compliance with the Regulations. This responsibility is proactive, meaning the Auditor must identify and disclose non-compliances regardless of whether the Company has included them in its SOC.

The fact that Annexure VI also requires auditors to independently identify and report non-compliance that the Company may have failed to disclose. The Auditor's role is to provide an objective and thorough review, ensuring that all material non-



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compliance is brought to light, thereby safeguarding the accuracy and completeness of the Company's corporate governance disclosures.

- (v) **Whether highlighting the non-compliance in the review report of 2023 absolves the Auditor from failing to report non-compliance in the review reports of 2021 and 2022?**

No, highlighting the non-compliance in the review report of 2023 does not absolve the Auditor from his failure to report non-compliance in the review reports of 2021 and 2022. The contravention of regulation 36(3) of the Regulations and regulation 6(i) of the Reporting Regulations for the years 2021 and 2022 still stands, as the Auditor was required to identify and report non-compliance during those years. The failure to do so indicates a lapse in fulfilling his regulatory obligations for the earlier periods.

7. In view of the aforesaid, the contravention of regulation 36(3) of the Regulations and regulation 6(i) of the Reporting Regulations at the relevant point of time has been established. I, therefore, in exercise of powers conferred under regulation 37 of the Regulations and regulation 7 of the Reporting Regulations read with section 512(2) of the Act, hereby conclude the proceeding initiated through the SCN by imposing a penalty of **Rs. 25,000 (Rupees Twenty-Five Thousand only)** on the Auditor and advise him to ensure compliance with the relevant provision of the law in future, in letter and spirit.

8. The Auditor is hereby directed to deposit the aforesaid amount of penalty in the designated bank account maintained in the name of the Securities Exchange and Commission of Pakistan with MCB Bank Limited within thirty (30) days of the date of this Order and furnish receipted bank challan, evidencing payment of the same, to the Commission forthwith. In case of failure to deposit the penalties, the proceedings under Land Revenue Act, 1967 will be initiated for recovery of the fines as arrears of land revenue.

9. Nothing in this Order may be deemed to prejudice the operation of any provision of the Act providing for imposition of penalties in respect of any default, omission, violation of the Act.

(Shahzad Afzal Khan)
Director/HOD
Adjudication Department-I

Announced:

Dated: August 30, 2024
Islamabad

