BEFORE APPELLATE BENCH NO. III

In the matter of

Appeal No. 90 of 2016

1. KPMG Taseer Hadi and Co. Chartered Accountants
2. Muhammad Nadeem, FCA, Engagement Partner of KPMG Taseer Hadi and Co. Chartered Accountants ...Appellants

Versus

Securities and Exchange Commission of Pakistan ...Respondent

Date of Hearing 05/01/17

Present: -

For the Appellants: -

1) Rahat Kaunain, Counsel
2) Gulalay Zeb, Counsel
3) Maham Ahmad, Counsel
4) Syed Iftikhar Anjum, KPMG Taseer Hadi and Co. Chartered Accountants
5) Muhamad Nadeem, KPMG Taseer Hadi and Co Chartered Accountants
6) Bakhtiyar Kazmi, KPMG Taseer Hadi and Co. Chartered Accountants

For the Respondent: -

1) Ali Azeem Ikram, Executive Director (Insurance)
2) Tariq Bakhtawar, Director (Insurance)

ORDER

1. This Order is passed in appeal No. 90 of 2016 filed under section 33 of the Securities and Exchange Commission of Pakistan (Commission) Act, 1997 (SECP Act) against the order (Impugned Order) dated 23/09/16 passed by the Respondent.

2. The Insurance Division of the Commission during the review of the Audited Accounts of Pak Kuwait Takaful Company Limited (Company) observed restatement of comparatives. It was disclosed in the Audited Accounts for year 31/12/14 that management identified various instances in the current year and previous years where liability for the claims were deliberately understated and endorsements were issued without documents to delay the provisioning requirements against outstanding contributions, policies being issued without adequate documentation. Resultantly, contributions, receivables, and related heads were overstated and claim liabilities and related accounts were understated. It transpired that the Audited Financial Statements and the Regulatory Returns of the Company along with Statements of Assets and Liabilities of the Company for the years ended 31/12/12 and 31/12/13 filed with the Commission under section 51 of the Insurance Ordinance, 2000 (Insurance Ordinance) were materially misstated. M/s. KPMG (Appellant No.1) acted as Statutory Auditors of the Company for the years 2012, 2013 and 2014.

   The brief facts leading to this case are that the Board of Directors of the Company in their meeting held on 01/12/14 decided to appoint M/s. Ernst & Young (EY) to carry out assessment of reserves against claims, examination of paid claims, identification of potential phantom agents and assessment of adequacy of bad debts and EY submitted their report on 06/03/15 with the following significant findings:

   a. The Reserve against Claims was understated and understatement as at 30/11/14 amounted to Rs.40,817 million.

b. Out of selected sample of 122 claims, supporting documents including the final surveyors reports and invoices of 32 claims amounting to Rs.1,914,694 were not made available to them and review of the remaining 90 claims disclosed that:
    - Alteration and/or removal of dates and amounts, by hand, on the surveyor reports and its underlying document;
    - Claim number and date generated before the accident, i.e. claim lodged in February 2014 and date of accident is June 2014;
    - Supporting bills of workshop are dated before the date of accident;
    - Incorrect details of policies in the surveyor report;
    - Claim approved on a Sunday (6 July 2014).

c. The comparison of the aging report and revised aging report identified that an additional provision of Rs.51.740 million was required for doubtful debts, as at 30/11/14.

d. It was observed that Sales Development Executive (SDE) Scheme Policies and Procedure Manual were not complied with in relation to recruitment of SDE. Furthermore, there was no policy at the Company for recruitment of cash & carry agents.

e. Agencies may be created in the name of family members of existing Company agents and/or employees. It was recommended that relationships, if any, should be disclosed in writing at the time of creation of an agency and should be approved. Furthermore, the disclosure and approval documents should be made part of agents' files. The management of the Company subsequently carried out an analysis of the EY report, to identify full impact of irregularities and identified the following:

f. Contribution due but unpaid as at 31/12/14 before adjustments amounted to Rs. 363.6 million and subsequent receipts there amounted to Rs. 83.042 million.

g. There were no recoveries of contributions aggregating to Rs 31.1 million (2012: Rs 105 million, 2013: Rs 1.89 million and 2014: Rs. 28.16 million) nor were they supported by adequately documented policies.

h. There were no recoveries of contributions aggregating to Rs.249.5 million (2012: Rs 20.17 million, 2013: Rs. 52.2 million and 2014: Rs.177.1 million), however, according to management they are supported by adequately documented policies. The specific reason for non-recovery have not been identified. According to the Company's policy, a provision of Rs.8.06 million has been made against the policies issued during 2014.

i. Claims at 31/12/12 were understated by Rs.30.8 million and at 31/12/13, they were understated by Rs.23.099 million.

j. The reversal of endorsements which were made without any adequate supports effected the provision for doubtful debts in the respective year.

3. The Appellant No.1 vide their Board Letter dated 24/04/15 forwarded the draft accounts of the Company to the Respondent for the year ended 31/12/14 together with draft audit report thereon. Among other things, Board concurrence and approval was sought in respect of restatement of comparatives and their confirmation that all material adjustments have been identified and recorded accordingly. In view of the above circumstances, the Respondent considered it necessary to obtain clarification on the said matters, especially whether Appellant No.1 as Statutory Auditors have discharged their responsibilities and performed work in accordance with the International Standards on Auditing (ISA) including ISA 240 (The Auditors Responsibilities Relating to the Fraud in an Audit of Financial Statements).

4. Show Cause Notice (SCN) was issued under section 48(2), 48(4) of the Insurance Ordinance read with section 255 and 260 of the Companies Ordinance, 1984 (Companies Ordinance) to the Appellants as to why necessary penal action may not be taken against them in terms of section 260 of the Companies Ordinance. The request of Appellant No.1 for extension in time was agreed by the Respondent and was extended to 23/05/16. The Appellant No.1 vide letter dated 23/05/16 submitted their written reply to the Notice, stating that they have fulfilled their responsibilities and

audit reports for the respective years are appropriate and are in conformity with the requirements of the law.

5. The Appellant No.1 was found to have committed a breach of fiduciary duty cast upon them by the policyholders as well as shareholders. After careful consideration of the conduct of the Appellant No.1 and the circumstances of this case, Mr. Muhammad Nadeem, FCA, (Appellant No.2) was found to have signed audit reports for the years 2012, 2013 and 2014 otherwise than in conformity with the requirements of section 48(2), 48(4) of the Insurance Ordinance read with section 255 of the Companies Ordinance. In exercise of the powers conferred under section 260(1) read with section 476 of the Companies Ordinance, instead of imposing penalty for violation each year, an aggregate fine of Rs.100,000/- was imposed on Appellant No.2.

6. The Appellants preferred the instant appeal on the following grounds:

a) The Impugned Order has failed to appreciate that the Appellants carried out the audit in accordance with the requirements of ISA. The Impugned Order does not explain why the Reply filed by the Appellants was not cogent. The Impugned Order fails to appreciate that the audit procedures carried out need to be looked at with the background where there was no information about the fraud and consider whether the procedures carried out without the knowledge of fraud were adequate or not. The holistic view of the facts and circumstances, in particular finding of fraud and collusion on part of senior management, read with the statutory protection conferred upon the Appellants as auditors vindicates the Appellants from any breach of law in the instant case, as elaborated hereunder:

(i) The Respondent has failed to recognize the inherent limitations of audit, due to which there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with ISA (ISA 240, Para 5). The Appellants contend that

even as acknowledged by ISA 200 (particularly A45), the auditor is not expected to and cannot reduce audit risk to zero. Therefore, this renders the auditor's opinion to be only persuasive rather than conclusive.

(ii) The Appellants submit that in Note 2.8 to the Financial Statements for the year ended 31/12/14 the 'Restatement of Comparatives' has been referred to and details such as inter alia deliberate understatement of liabilities have been disclosed rendering the true and fair status of the Company. This shows that the intent of the Appellants was neither to deceive nor conceal anything from the stakeholders of the Company nor could it be attributed to a "failure to bring out material facts about the affairs" of the Company which has also not been relied as basis in the SCN. Furthermore, with respect to Paragraph 15 of the Impugned Order, the ISA 560 'Subsequent Events' is not relevant as the Appellants were not required to revise their audit report. Based on identification of irregularities in the year 2014, the full impact of irregularities in the year 2014 was determined and recorded in the financial statements 2014. As the matter was already fully disclosed in the financial statements, therefore an "Emphasis of Matter" paragraph was not considered necessary. More importantly, the ISA particularly recognizes that where there are misstatements resulting from fraud, the risk of not detecting such a misstatement is significantly higher as compared to a misstatement resulting from error (ISA 240 Para 6). Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than the employee fraud, for the plain reason that management is in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees (ISA 240 Para 6). Therefore, in the case of collision, fabricated, sophisticated and carefully organized schemes to conceal may cause the auditor to believe that the audit evidence is persuasive, when it is in fact false (ISA 240 Para 6). Nevertheless, the primary responsibility for the prevention and detection of fraud rests with those charged with governance of the entity and management (ISA 240 Para 4).

(iii) The Appellants carried out client and management evaluation prior to commencement of work and they assigned appropriately qualified and trained personnel to the engagement. Risk assessment was performed at both entity and account level and planned audit approach was developed based on the risk assessment. According to risk assessment conducted at the beginning of each audit, the Appellants' assessment was that the Company had a well-qualified board, qualified and trained management with no integrity issues and reasonably designed and controlled processes. The tests performed included test of controls for all significant processes and substantive procedures for all significant account balances. The work papers were appropriately reviewed by partner and manager and appropriate representations were obtained from management.

b) In terms of section 260(1) of the Companies Ordinance, the Commission is empowered to impose a penalty if it is satisfied that the "default is willful". In this regard, the Commission in its own order in the case of *Sherman Securities (Pvt.) Ltd v Joint Director (SMD) Securities and Exchange Commission of Pakistan* cited at *2012 CLD 612* defined the term 'willful' while placing reliance on the definition of 'willful' as reproduced in Black's Law Dictionary "*as an act done with stubborn purpose, but not with malice, as done intentionally, knowingly and purposely as distinct from an act done carelessly, thoughtlessly, heedlessly or inadvertently.*" The Impugned Order, however, has attempted to make it an offence of strict liability, which is not the intent of the statute i.e. provision of section 260(1) of the Companies Ordinance. The Impugned Order has further failed to establish or even refer to the intention of the Appellants. The Appellants submit that the audit was planned and performed in accordance with ISA, the default, if any, cannot be termed as willful default. The view taken in the Impugned Order is diametrically opposed to the view expressed and adopted earlier by the Commission and consistently followed by the Courts. Reliance is placed on the judgments of *Sherman Securities cited at 2012 CLD 612; Kora Khan v Director-General Agriculture Department, Government of Balochistan cited at 2011 PLC (C.S) 842; Muhammad Nawaz Sheikh v Manzar Hassan and others cited at PLD 2011 Lahore 531; Mirza*

Shaukat Baig and others v Shahid Jamil and others cited at PLD 2005 SC 530; Nasrullah and another v Haji Usman Ghani and 5 others cited at 2002 CLC 1925)

c) The Impugned Order fails to appreciate that even in the EY Report at Page 40, it has been expressly stated while pointing out the limitations of the audit that "*it follows that if the information provided to us by PKTCL was inaccurate, wrong, incomplete or unclear or if further information comes to light, this may likewise have affected the completeness and accuracy of any analysis in this report. In substance, the findings are based on the information provided by the management and specific enquiries undertaken; this was also the case when the Appellants undertook the audit. However, as acknowledged the possibility of the findings being further revised cannot be ruled out. Hence, appreciating the above position, any absolute obligation or breach thereof cannot be alleged against the Appellants.*"

d) Finding of breach of fiduciary duty as well as the imposition of penalty on the Appellants was wrong and mistaken. In this regard attention is drawn to section 255(7) of the Companies Ordinance which is to be read with the order of the Commissioner, Insurance Division dated 24/08/16 passed against the Chairman, Chief Executive, Directors of the Company and the Company itself. The Commissioner's Order was passed under section 11(1)(f) and 12(1) read with section 158 of the Insurance Ordinance, holding the Chief Executive and Directors liable for not managing the business in a second and prudent manner. This may be read together with section 255(7) of the Companies Ordinance, which makes provision for a penalty to be imposed on officers of a company for not providing an auditor with access to books or any information possessed by him. The provisions of section 260(1) of the Companies Ordinance become inapplicable since the Commissioner's Order has already found the management guilty. The information provided was deliberately distorted by the management itself and was not shared with the auditor. Furthermore, the primary responsibility for preparation of the financial statements which present true and fair view rests with the Board of Directors. Therefore, as the management has been found guilty in the Commissioner's Order for misrepresenting facts and figures, the Appellants should be relieved of any liabilities in

relation thereto. With respect to policy holders, no loss has been suffered by them as all the claims are acknowledged by the Company and only recording of claims has been delayed. The Appellants while relying on ISA 200 submit that an audit is conducted on the premise that management and those charged with governance acknowledge and understand that they have responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The management is also responsible to provide the auditor with access to all relevant information for preparation of the financial statements; as well as additional information that the auditor may request; and unrestricted access to persons within the entity, from whom the auditor determines it necessary to obtain audit evidence (ISA 200-A2).

e) The Respondent has failed to take into account that the EY Report was in fact subsequent to the issue of fraudulent reporting surfacing and the investigation was specifically carried out for the purpose of ascertaining whether or not fraud had been committed. Therefore, drawing such distinction is crucial as once the knowledge that fraud has been committed is present, all analysis and management reports and statements of claims analysis are performed with that bearing in mind. Reliance is placed in the matter of *Tri-Sure India Ltd V.A.F. Ferguson and Co and Others* cited at *1987 61 Comp cas 548 Bom,* wherein, it was held that, "*In judging whether an auditor exercises reasonable care and skill, it would not (Sic) appropriate to proceed on matters which have subsequently transpired, but one must place oneself in the position of the auditor as when the accounts were audited and find out how the matters appeared [Sic] for ought to have appeared to a man of reasonable care and skill.*"

Therefore, as also recognized by the ISA 200 (particularly A47) an audit is not an official investigation into alleged wrongdoing and the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation and an auditor merely has to employ reasonable care and skill depending on the circumstances of each case.

f) The Respondent has incorrectly concluded that the understatements were apparent from the data/information available in the Audited Statement of Claim Analysis. The Commission performed off sight monitoring on a quarterly basis and on site monitoring on annual basis of insurance companies, however, no observations relating to misstatements were made by the Commission until a year after such misstatements were fully disclosed and restated in the audited financial statements for the year ended 31/12/14. An inspection of the Company was also conducted in 2013 covering period up to 31/12/12 and no unusual observation was made. Attention is also drawn to another order of the Commission dated 03/08/15 under section 36 and section 46(6) read with section 11(1) of the Insurance Ordinance in relation to Statement of Compliance filed for the year ended 31/12/13 (Solvency Order). Under the Solvency Order, the Commission while reviewing the financial statements for the year ended 31/12/13 observed that the Company was insolvent. Such observation was made from Note 7 of the financial statements for the year 2013; wherein it was specifically disclosed that the Company has been unable to meet solvency related requirements. The Appellants submit that the figures as reported by the Company were not challenged by the Commission at the time of the Solvency Order despite the fact that the EY Report as well as restatements for the year ended 31/12/12 and 2013 were on record.

g) The Impugned Order omits to consider that the Appellants disclosed issues, which appeared to be only weaknesses and departures from policies and procedures. However, since adequate reasons were provided by the management for such departures negating the likelihood of commission of fraud, the explanations were accepted. The management letters were reviewed by the audit committee and the Board of Directors, none of whom highlighted any concerns that there may be an indication of misstatements or fraud.

h) The principles of natural justice deem it necessary for an opportunity of hearing to be given to a party to address and respond to all allegations made against it. The Respondent in Paragraphs 16 and 19 of the Impugned Order has respectively referred to contents of the Management Reports submitted by the Appellants during the hearing of 21/07/16 as well as a Claims Development Table. The Appellants, however, were never apprised of

or given the opportunity of responding to such evidence either in SCN or during the hearings held. The principles of natural justice also envisage that the material being relied upon as evidence against a person must be confronted to him for his comments and rebuttal. The Claims Development Table produced in the Impugned Order has been prepared by the Respondent based on statutory returns submitted from 2011 to 2015. The Appellants, however, while doing the audits of statutory returns for the year 2012 and 2013 did not have such table and subsequent returns. The Table comprises of gross claims expense for respective claim year and does not take into account reinsurance recoveries. On a net claims expense basis, the overall shortfall in 2012 would stand greatly reduced. Therefore, through review of each year of statement of claims analysis, the misreporting is not apparent unless you are aware that the misreporting has been done. At the time of the audit for years 2012 and 2013, the Appellants by using statutory returns could only compare provisions made in 2011 and 2012 respectively with claim expense recorded in 2012 and 2013. On a net basis, shortfall in respect of prior years (earlier than 2013) was approximately Rs.11 million. Furthermore, estimation of claims liability involves judgment based on information available when the financial statements were prepared and for many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management. The EY Report states that the assessment of reserves maintained against the outstanding claims based was on surveyor's estimates and other information provided. In case of the Appellants, at the time of conclusion of audits for 2012 and 2013, surveyors' estimates were not provided in many cases, therefore, understatement of reserves could not be identified.

i) Paragraph 13 of the Impugned Order fails to appreciate that the average claims of Rs.27,500/- cited are claims during the period January 2014 to 30/11/14 and reserves at 30/11/14 at Rs.10,000 per claim. The audit of 2014 financial statements was finalized

after December 2014 and Appellants had no responsibility to review the position at 30/11/14 which the Appellants did not look at. The Appellants only had the responsibility to report on the financial statements as at 31/12/14. The response as to why tests performed on sample basis could not identify the payments made on Sundays was that the Appellants carry out a small sample, size of which is determined on a statistical basis as opposed to the size of sample in a fraud investigation. Furthermore, when sample is selected as per ISA 530 there is an equal possibility for a transaction to be selected or not selected for the purpose of said sample. Therefore, it is not necessary that the sample would identify all irregularities. EY was appointed to carry out an exercise which is distinct from the audit of financial statements. EY work was targeted towards known areas and they were guided by persons who had full knowledge of the fraud and their sample was a judgmental sample i.e. only those claims were selected which had irregularities. The management explained the instances noted of endorsements without adequate supports as valid endorsements which are not uncommon in insurance. The endorsements are made to record any changes to the policies and these changes can be of several nature e.g. change of asset, change of agent etc. The tests carried out by the Appellants in 2012 and 2013 did not identify any fake endorsements. The EY Report in its assessment of adequacy of bad debts discovered that the outstanding delays in the 'Outstanding Contribution Register – Client and Policy' were being computed from the posting date of the last endorsement passed against the policy instead of the effective date of the policy, i.e. when the balance actually became due. The incorrect dates were incorporated in the Register by the management and this was done deliberately to distort the overdue balances. The Appellants had unknowingly placed reliance on the misstated figures as provided in the Register, resulting in the overdue balances being understated. The Respondent's reference to IFRS-4 in Paragraph 18, and specifically the 'Liability Adequacy Test' and disclosure of information, appears to be of no relevance. The Liability Adequacy Test is carried out to determine whether there is any deficiency in premiums. In general, for the type of business carried out by the Company, this estimation is not significant. This is not directly linked or has relevance to whether the

reserves cover claims or not (as was the concern in the Impugned Order in relation to the understatement of claim liability). Furthermore, in General Insurance/Takaful industry, the certainty about the amount and timing of claims payment is typically resolved within one year. Therefore, disclosure referred in the Impugned Order is not mandatory and generally not presented in the financial statements of General Insurance/Takaful Companies.

7. The Respondent rebutted the arguments of the Appellants on the following grounds:

a) The representations on the audit procedures, both written as well as representations during the hearing were taken into consideration in paragraph 12 of the Impugned Order. Moreover, with respect to the reply submitted by the Appellants vide letter dated 23/05/16, it may be appreciated that the contents of the reply are thoroughly discussed in the Order's paragraphs No. 7,8,9,10 and 11 along with the rationale on why the Reply of the Appellant was not found cogent, considering that if appropriate auditing procedures were carried out in obtaining audit evidence on "Contribution Due", "Outstanding Contributions", 'Provisioning for outstanding Claims' and 'reversal of endorsements' they could have identified the irregularities during the statutory audits for the years 2012 and 2013. The misreporting by the management was primarily carried out in the areas of underwriting and claims, and in the Impugned Order, the Appellants' responsibilities and obligations in the background ISA has been discussed in quite detail. The management letter issued by the Appellants in the years 2011, 2012 and 2013 draw attention on the issues related to the contribution and high level of risks associated with them. Moreover, The IFRS-4 (Insurance Contracts) specifies the financial reporting requirement for insurance contracts and disclosures, which would have supported the Appellants to discharge their obligations. Paragraph 16 of the Impugned Order highlights that high risks associated with Takaful Contracts, Contribution due, but unpaid and Endorsement of policies were identified by the Appellants in their management letters which are quoted below for ready reference:

Years 2011 and 2012: Takaful Contracts

Instances were noted where Takaful Contracts were not supported by any document as required by Company's underwriting policies and procedures. The implications arising from the observations were non-compliances of the Company's Policies and Procedures along with increase in chances of fraud and errors. The recommendations suggested that the management should strengthen the control over the proper and complete documentation of Takaful Contract to comply with the Company's Policies to avoid any complication in future and all policies should be duly approved by underwriting head as per Company's Policy.

Years 2011 and 2012: Contribution due but unpaid

The Appellants noted that the Company's contribution written during the year has increased whereas admissible assets over liabilities have decreased as compared to last year. The major reason for decrease in admissible assets is increase in outstanding balances against contribution due but unpaid for more than three months which represent low recovery during the year. This may result in Financial Loss to the Company and Liquidity problem to the Company. The Appellants suggested that management should take necessary steps for recovery of outstanding contribution in order to avoid Financial Loss to the Company and Risk of Liquidity problem.

Years 2012 and 2013: Endorsement of Policies (Intimation Letter Missing)

Certain endorsements were carried out on the basis of telephonic conversation by the customer without proper documentation. The implication arising from the observation was non-compliance with the Company's policies and procedures which may increase in chances of fraud and error and risk of loss of audit trail and also disagreement may arise with the participants. The recommendations suggested that a letter envisaging the desire of customer for endorsement could be obtained before every endorsement to avoid any discrepancies in future. In view of the high risks already identified by the Appellants, they should have remained professional skeptical throughout the audit, recognizing the possibility that a material misstatement may occur. "Professional Skepticism" definition provided in ISA is that "*An attitude that includes a questioning*

mind, being alert to conditions which may indicate possible misstatement due to error of fraud and critical assessment of evidence".

Likewise, paragraphs 18 and 19 of the Impugned Order deliberated how Appellants could have benefited from IFRS-4 in discharging their responsibilities and obligations. The Appellants were also auditors of the regulatory returns of the respective years including Claim Statement which provided comprehensive data/information on the claims. The claims data conclusively indicated that during the years 2012 and 2013, the liability for claims was understated by the Company and the estimates against the claims cost was not adequately provided. Similarly, other observations of the Appellants in their management letters, substantiate the stance that the auditors were well aware of the irregularities being carried out in the respective periods 2012 and 2013. Therefore, the stance of the Appellants on the inherent limitations of audit lacks merits.

b) The disclosure of Note 2.8 if the financial statements for the year ended 31/12/14 by the management of the Company that all irregularities and fraudulent activities along with adequate disclosures and restatements does not diminish the Appellant's responsibilities and duties as auditors for respective years. It is beyond the inherent limitations of audit, as the Appellants in their management letters for the respective years had already identified the increased chances of fraud and error and the audited accounts were supposed to be in compliance of IFRS-4.

c) The engagement evaluation and risk assessment have been discussed in detail in paragraphs 9,10 and 11 of the Impugned Order. The Appellants in their management letters for the respective years had already identified the issues in question. After identification of the risks, the Appellants failed to perform audit procedures accordingly in line with the requirements of ISA.

d) Reference may be made to the Appellate Bench's order in the case of *Shaikh Jalaluddin, FCA vs. Commissioner (Enforcement)*, which was upheld by the Honourable Sindh High Court in an appeal filed by the auditor in that case. In the said order the auditor who was penalized argued that his default was not willful although he had failed to comply with the provisions of the law and applicable auditing standards. The Appellate

Bench while holding that his default was indeed willful observed that in case of City Equitable Fire Insurance Co. Ltd Re, 1925 Ch 407, "*it was held that a default, in case of breach of duty, will be considered "willful" even if it arises out of being recklessly careless, even though there may not be knowledge or intent. Simply put, if the Appellant admits to know the auditing standards and claims to have followed them when in reality, as proven above he has not, then keeping in view his status as a professional and his duty as a fiduciary he should be held to be willfully in default.*" In the instant case, the Appellants admit to be acquainted with the ISA and in their reports claimed to have followed them. Therefore, the Appellants may be held to be willfully in default. The word "willful default" has been defined in Oxford Dictionary of Law Fifth Edition as "*The failure of the person to do what he should do, either intentionally or through recklessness.*" The argument of the Appellants that the default was not "*willful*" holds little merit as even there may not be knowledge or intent, the Appellants did not exercise the due skill and care required of them as directors of the Company at the time of issuing the audit reports for the respective years.

e) The Appellants are mingling the findings of EY Report dated 06/03/15 with the audit performed for the years 2012 and 2013. The Appellants were also auditors of the regulatory returns of the respective years including Claim Statement which provided comprehensive data/information on the claims. The claims data conclusively indicated that during the years 2012 and 2013, the liability for claims was understated by the Company and the estimates against the claims cost was not adequately provided. Similarly, other observations of the Appellants in their management letters, substantiate the stance that Appellants were well aware of the irregularities being carried out in the respective periods 2012 and 2013.

f) The provisions of section 255(7) of the Companies Ordinance are irrelevant to correlate the instant order with the Order dated 24/08/16 passed by the Commissioner (Insurance). Order dated 24/08/16 was passed by the Commissioner (Insurance) on contravening the provisions of section 11(1)(f) and section 12(1) of the Insurance Ordinance and not managing the business in a sound and prudent manner. The instant Order was passed

against the Appellants on signing the audit reports for the years 2012, 2013 and 2014 otherwise than in conformity with the requirements of section 48(2), 48(4) of the Insurance Ordinance read with section 255 of the Companies Ordinance and penalty, therefore, was imposed under section 260(1) read with section 476 of the Companies Ordinance.

g) The underlying information/data disclosed in the Claim Statement indicated under-provisioning of the claims cost by the Company and is acknowledged by the Appellants. The Claims Development Table prepared on the basis of underlying data disclosed in the Audited Statement of Claims by the Appellants, indicate under-provisioning of the claims cost by the Company. The understatement remaining was overlooked by the Appellants. Moreover, it was an assurance engagement of the Appellants with a wide scope to perform audit procedures to obtain sufficient evidence and appropriate evidence in order to express the conclusion to enhance the degree of confidence of the intended users other than the management of the Company. Therefore, the Appellants' attempt to correlate with the fact that it was previously not monitored by the offsite or onsite team of the Commission does not lessen the strength of the observation. The Appellants had not adopted the appropriate procedures to reduce the assurance engagement risk to a low level. The Appellants could have been alerted to express the opinion that the matter is being materially misstated. In the inspection report of 2013, it was highlighted that there is a significant increase in outstanding contributions of the Company and correlating the increase with increase in provision for doubtful receivables in the respective years should also have alerted the Appellants.

h) The reference to an Order issued against the management of the Company on failure to meet the solvency requirement is irrelevant. The responsibilities of the Appellants may not be undermined or diminished by referring to the previous order of the Commission dated 03/10/15 under section 36 and section 46(6) read with section 11(1) of the Insurance Ordinance. The instant Order determines the discharge of duties and responsibilities by the Appellants as auditors while expressing their opinion.

i) The Appellants audited the regulatory returns for the respective years including Claim Statement which provided comprehensive data/information on the claims during the years 2012 and 2013. The liability for claims was understated by the Company and the estimates against the claims was not adequately provided. Moreover, IFRS-4 – "Insurance Contracts" specifies the financial reporting requirement for insurance contracts and disclosures. The Liability Adequacy Test and information on Claim Development referred in paragraphs 14-20 and paragraphs 38-39 of IFRS-4 provide that actual claims to be compared with previous estimates (i.e. claims development). In the event, the Appellants had justifications for adequate reasons provided by the management for departure from this requirement, then the same could have been offered in the financial statements. The risk highlighted in the management letters were significant and the Appellants being the author of these management letters were well aware of the irregularities being carried out in the respective periods 2012 and 2013. In view of the high risks already identified by the Appellant, they should have remained professional and skeptical throughout the audit, recognizing the possibility that a material misstatement may occur. The Appellants were also auditors of the regulatory returns of the respective years including Claim Statement Analysis and the Statement provided comprehensive data/information on the claims. The claims data conclusively indicated that during the year 2012 and 2013, the liability for claims was understated by the Company and the estimates against the claims cost was not adequately provided. Similarly, other observations of the Appellants in their management letters, substantiate the stance that the Appellants were well aware of the irregularities being carried out in the respective periods 2012 and 2013. The Appellants while performing the audit were responsible for analyzing the understatement of estimations. The response that the sample size was small is again not a cogent reason. Keeping in view the risk associated with the transactions, the Appellants were required to adopt the appropriate audit procedures. Management letters for the year 2012 and 2013 discuss the endorsement issues and the Appellants should have maintained professional skepticism in the area of endorsement which they failed to do so until EY highlighted in its report.

j) The Appellants themselves were available for personal hearing, therefore, no rule of natural justice had been infringed. Moreover, the management letters for the respective years were presented by the Appellants during the course of hearing and were extensively debated. Furthermore, the claim development table is a populated presentation of data provided in Claim Statement analysis for the respective years which were also audited by the Appellants and is a matter of established facts.

8. We have heard the parties i.e. Appellants and the Respondent. The Appellants have stated that they carried out the audit in accordance with the requirements of ISA. Furthermore, the Appellants argued that the Respondent has failed to recognize the inherent limitations of audit and, therefore, collision and carefully organized schemes may cause the auditor to believe that the audit evidence is persuasive, however, the primary responsibility to detect any fraud rests with those governing the entity. The Respondent has rebutted the arguments of the Appellants by stating that the misreporting by the management was primarily carried out in the areas of underwriting and claims and the risks highlighted in the management letters were significant, therefore, in view of the high risks already identified, the Appellants should have remained professional and skeptical throughout the audit, recognizing the possibility that a material misstatement may occur.

9. We place our reliance on paragraph 4 of ISA 240, wherein, it is stated that, "*The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment...*" Furthermore, we place our reliance on paragraphs 5-8 of ISA 240, wherein, it is stated that, "*An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be*

detected, even though the audit is properly planned and performed in accordance with the ISAs...The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is in fact, false... While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees. While obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud..."

10. In light of the above, we are of the view that while it is correct that the auditor should maintain his professional skepticism throughout the audit, the primary responsibility for the prevention of fraud rests with those charged with governance and it is very difficult for an auditor to detect fraud when the management of the Company itself is involved. Furthermore, recommendations given by the Appellants in the management letters were in line with the observations made during the audit. On the other hand, the investigation by EY was conducted for the purpose of detecting fraud and their scope of audit was materially different from the scope of annual audit conducted by the Appellants, therefore, it would be unfair to compare the audit of the Appellants with that of EY. Reliance is also placed on the judgment of *Tri-Sure India Ltd vs A.F. Ferguson And Co. And Others* cited at *1987 61 CompCs 548 Bom*, wherein, it was held that, "...*The*

International Auditing Guideline No.1 published in January 1980, prescribes that while the auditor is responsible for forming and expressing his opinion on the financial statements, the responsibility for their preparation is that of the management of the entity. The management's responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies, and the safeguarding of the assets of the entity. The audit of the financial statements does not relieve the management of its responsibilities...The auditor does not conduct the audit with the objective of discovering all frauds, because in the first place it would take a considerable amount of time and it would not be possible to complete the audit within the time-limit prescribed by law for the presentation of accounts to the shareholders. Further, such an audit would have to involve a detailed and minute examination of all the books, records and other documents of the company, and the cost of doing so would be prohibitive and disproportionate to the benefits which may be derived by the shareholders. Finally, even if such examinations were to be conducted, there will be no assurance that all types of frauds, omissions and forgery, etc. would be discovered...The auditor is required to employ reasonable skill and care, but he is not required to begin with suspicion and to proceed in the manner of trying to detect a fraud or a lie, unless some information has reached which excites suspicion or ought to excite suspicion in a professional man of reasonable competence. An auditor's duty is to see what the state of the company's affairs actually is, and whether it is reflected truly in the accounts of the company, upon which the balance sheet and the profit and loss accounts are based, but he is not required to perform the functions of a detective. What is reasonable care and skill must depend upon the circumstances of each case..."

11. In the instant case we have no reason to believe that the audit conducted by the Appellants was not properly planned or performed in accordance with the requirements of ISA; merely on the ground that they failed to detect management's material misstatements due to fraud. Moreover, it is established and recognized by ISA that the risk of not detecting material misstatement by the auditor in case of management fraud is more likely. In the instant case, the management has defrauded not only the Board of Directors of the Company but also the Appellants through

organized scheme of forgery, intentional misrepresentations and failure to record transactions. It is also important to note that this management fraud was committed in such a sophisticated manner that it had remained undetected even in the SECP's onsite/offsite monitoring.

12. Therefore, in view of the above, the Impugned Order is set aside with no order as to costs.

(Zafar Abdullah)
Commissioner (SCD)

(Tahir Mahmood)
Commissioner (CLD)

Announced on: 09 FEB 2017