Corporate Supervision Department
Company Law Division

Before Abid Hussain – Executive Director (CSD)

In the matter of

Mr. Farooq Hamid, Auditor Engagement Partner of Hassan Farooq & Co., Chartered Accountants - Auditor of Ghani Automobile Industries Limited

Number and date of notice:	CSD/ARN/280/2015-3522, dated March 7, 2016
Date of hearings:	May 4, 2016
Present:	Mr. Farooq Hamid, the Respondent

ORDER

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

This order shall dispose of the proceedings initiated against Mr. Farooq Hamid, (the "respondent"), audit engagement partner of Hassan Farooq & Co., Chartered Accountants (the "Auditor") who audited the annual financial statements (the "Accounts") of Ghani Automobiles Industries Limited (the "Company") for the year ended June 30, 2015. The proceedings were initiated through show cause notice ("SCN") dated March 7, 2016 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 the Accounts filed with the Commission under section 233 of the Ordinance revealed that the Company recognized 'Discount on Issue of Shares' amounting to of Rs150,000,000 (2014: Nil) as 'Non-current Assets' in the balance sheet. Note 11 to the Accounts further disclosed, as under:

> *"Discount on Issue of Shares: The Company has issued thirty million ordinary shares of Rs.10 each at 50% discount in accordance with the provision of sections 84 and 86 of the Ordinance. The discount on issue of shares shall be amortized over a period of five years starting from December 2015 to December 2020."*

Review of the interim accounts the period ended September 30, 2015 ("Quarterly Accounts") revealed that the Company amortized the 'Discount on Issue of Shares' by Rs5 million reducing it to Rs145,000,000 and the amortization was charged to Statement of Comprehensive Income.

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3. The aforesaid treatment of recognizing the 'Discount on Issue of Shares' as an asset and amortizing it through Statement of Comprehensive Income was, prima facie, in contravention with the requirements of applicable International Financial Reporting Standards ("IFRS") including the International Accounting Standards ("IAS"), in terms of which the Company was required to charge the amount of 'Discount on Issue of Shares' directly to the equity and show it as a deduction from equity. Due to the aforesaid accounting treatment adopted by the Company in contraventions with requirements of IFRS, the Accounts of the Company have been, prima facie, misstated and effect of misstatement was material, as stated below:

Particulars	Amount actually reported	Amount if correctly reported	Amount of Misstatement	Misstatement as % of Correct amount
Shareholders' Equity	367,330,723	217,330,723	150,000,000	69%
Non-Current Assets	211,171,246	61,171,246	150,000,000	245%

The Company also, prima facie, failed to account for the directly attributable transaction costs in relation to issue of shares as a deduction from equity (net of any related income tax benefit) and give separate disclosure of such costs was also required.

4. The Auditors having audited the Accounts gave an unmodified opinion in the report to members thereon and also did not highlight any of the aforesaid non-compliances with requirements of IFRS and its quantified impact. In view of the applicable provisions of the Ordinance, the rules made thereunder and the International Standards on Auditing ("ISAs"), the Auditor was required to appropriately modify the opinion with regard to misstatement in the Accounts due to the aforementioned non-compliances by the Company with the requirements of the IFRS. The Auditor in the report to members on the Accounts, prima facie, failed to modify the opinion with regard to the material misstatements arising out of the aforementioned non-compliances of IFRS. Therefore, the Auditor's report on the Accounts was, not in accordance with the requirements of section 255 of the Ordinance and ISAs as it, prima facie, failed to bring out material facts about the affairs of the Company making the respondent liable for action under section 260 of the Ordinance. Consequently, the SCN was issued to the respondent calling upon him to explain as to why penal action may not be taken against him under section 260 of the Ordinance.

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5. In response to the SCN, the respondent reply was received on March 22, 2016, wherein with reference to the SCN, he stated as under:

> *"The information disclosed about discount on the issue of shares was not accordance with the requirements. However, the said disclosed information in the Accounts did not benefit or afflict any loss to any individual or group of persons, associated with the Company as a shareholder and / or a stakeholder. We frankly admit the unintentional mistake. It was neither willful nor with a mala fide. We took up the matter with the Company's management who are also of the view that there is a mistake, but it was not intentional or with any other motive to afflict loss to any shareholder.*
>
> *The mistake in the annual and quarterly accounts was a procedural inadvertent mistake. As per information received from the Company and as a matter of fact, the Company has ratified its record for the ensuing quarter according to legal disclosure requirements and in line with the relevant portion of IFRS. The quarterly accounts for period ended March 31, 2016 will be placed on website and will be filed with the Commission, as required."*

Based on the above submissions the respondent requested to withdraw the SCN and also required to provide an opportunity of hearing.

6. The case was fixed for hearing on May 4, 2016 and Mr. Farooq Hamid appeared before the undersigned. He mainly reiterated his earlier stance as per the written submissions and requested for a lenient view. He further stated that the mistake regarding treating the discount on issue of shares as a deferred cost was due to misunderstanding; however, it was not with *mala fide*. He further stated that the confusion also arose due to provisions of section 84 of the Ordinance which requires that the balance sheet shall contain the particulars of the discount allowed on issue of shares or of so much of discount as has not been written off at the date of issue of balance sheet. He admitted the incorrect accounting treatment adopted by the Company and that it was overlooked by the Auditor. However, stating that since the mistake has been ratified in the quarter accounts for period ended March 31, 2016, he requested for a lenient view.

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7. Before proceeding further, it is necessary to advert to the following relevant provisions of the Ordinance, the Rules, IFRS and ISAs regarding auditor's responsibilities:

IAS 1 - Presentation of Financial Statements

109. Changes in an entity's equity between the beginning and the end of the reporting period reflect the increase or decrease in its net assets during the period. Except for changes resulting from transactions with owners in their capacity as owners (such as equity contributions, reacquisitions of the entity's own equity instruments and dividends) and transaction costs directly related to such transactions, the overall change in equity during a period represents the total amount of income and expense, including gains and losses, generated by the entity's activities during that period.

IAS 32 – Financial Instruments: Presentation

37. An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity (net of any related income tax benefit) to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognized as an expense.

IAS 38-Intangible Assets *(Para 8)*

An *asset* is a resource:

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

An *intangible asset* is an identifiable non-monetary asset without physical substance.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

The Conceptual Framework for Financial Reporting (the "Framework")

4.25 (b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

4.8 The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

4.44 An asset is recognized in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

4.45. An asset is not recognized in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead such a transaction results in the recognition of an expense in the income statement. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant the recognition of an asset.

ISA 705 -Modifications to the Opinion in the Independent Auditor's Report

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*

A4. *In relation to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise when:*

(a) The selected accounting policies are not consistent with the applicable financial reporting framework; or

(b) The financial statements, including the related notes, do not represent the underlying transactions and events in a manner that achieves fair presentation

A6. *In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:*

(a) When management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or

(b) Due to the method of application of the selected accounting policies (such as an unintentional error in application)

A7. *In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:*

(a) The financial statements do not include all of the disclosures required by the applicable financial reporting framework;

(b) <u>The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework</u>; or

(c) The financial statements do not provide the disclosures necessary to achieve fair presentation. (emphasis added)

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)"

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

Rule 17 (A) of the Companies (General Provisions and Forms) Rules, 1985 (the "Rules") states that the auditors' report on the accounts and books of accounts and balance-sheet and profit and loss account of a company required by section 255 of the Ordinance shall be on a prescribed format contained in FORM 35-A, and the prescribed format, inter alia, contains the statement by the auditor that *"we conducted our audit in accordance with the auditing standards as applicable in Pakistan"*.

Section 255 of the Ordinance prescribes powers and duties of the auditors and sub-section (3) of section 255 prescribes requirements, manner and content of auditors' report on the Accounts.

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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."*

In terms of the Commission's notification SRO 1003 (I)/2015 dated October 15, 2015, the powers to adjudicate cases under section 260 of the Ordinance have been delegated to the Executive Director (Corporate Supervision Department).

8. I have analyzed the facts of the case, relevant provisions of the Ordinance and the arguments put forth by the respondents and my observations are as under:

a) The Framework and the IFRS do not have a concept of deferred costs. To recognize a deferred cost as an asset, we have to look up for the definition of an asset and the criteria for recognition of assets in the Framework and the IFRS. As per IAS 38, an asset is a resource controlled by an enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. IAS 38 defines an *intangible asset* as an identifiable non-monetary asset without physical substance and a *monetary asset* as the money held and asset to be received in fixed or determinable amounts of money. Since the discount on issue of shares neither falls within the definition of 'asset' nor does it meet the criteria for recognition of an asset, therefore, it cannot be recognized as a deferred cost or an asset.

b) In terms of the Framework, the expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of

liabilities that result in decreases in equity, other than those relating to distributions to equity participants. The amortization of discount on issue of shares does not meet the definition of expense either. Para 4.20 of the Framework states that although equity is defined in paragraph 4.4 as a residual, it may be sub-classified in the balance sheet. For example, in a corporate entity, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments may be shown separately. Likewise, cost of equity transactions are comprised of only those incremental external costs directly attributable to equity transactions, which would otherwise have been avoided. The transactions costs for equity transactions should be accounted for as a deduction from equity, net of any related income tax benefit. As the discount on issue of shares is not a payment, it would not fall strictly into any of these categories. Moreover, the equity should be the net amount received by an enterprise. Moreover, the IFRS do not have any concept of deferred cost / expenditure. Therefore, the discount on issue of shares should be shown as a deduction from equity and should not be recognized as deferred cost.

c) The Company's treatment of recognizing the discount on issue of shares as 'deferred cost' under the non-current assets is clearly in violation of the requirements of IFRS and the Framework. Due to this incorrect accounting treatment the 'shareholders' equity' and 'non-current assets' in the Accounts of the Company were misstated by 69% and 245%, respectively.

d) In terms of para 37 of IAS 32, the Company was required to account for the directly attributable transaction costs in relation to issue of shares as a deduction from equity (net of any related income tax benefit) and separate disclosure of such costs was also required under IAS 1. However, the Company did not recognize any costs associated with the issuance of shares in the Accounts 2015 in terms of applicable provisions of the IFRS and also did not give separate disclosures of such costs in terms of IAS 1.

e) The ultimate responsibility of preparing the financial statements in accordance with the Ordinance and IFRS including the IASs rests with directors. It is the duty of the statutory auditor of a company to express an independent opinion including, inter alia, the opinion

as to whether or not the financial statements confirm with the approved accounting standards that comprise the IFRS, IAS. The Ordinance and IFRS require that financial statements should present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses. This necessitates adequate disclosure and full compliance with all applicable IFRSs.

f) A statutory auditor is bound to follow the requirements prescribed by the Ordinance, the Rules and the ISAs and has to express an opinion remaining within the confines set by them. The ISAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit. In terms of the ISAs it is auditor's duty to identify and assess risks of material misstatements, obtain sufficient appropriate evidence and form an opinion based on conclusions drawn from the audit evidence. Para 8 of ISA 200 clearly states that the form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable law or regulation. (Ref: Para. A12–A13).

g) Preparation of financial statements is responsibility of the management and it is auditor's responsibility to express an independent opinion on the financial statements. The auditor is required to specifically give an opinion as to whether or not the financial statements have been drawn up in conformity with the IFRS. It is his duty to highlight any non-compliance with the requirements of IFRS in preparation of Accounts. The Company's incorrect treatment of recognizing the discount on issue of shares as 'deferred cost' under the non-current assets was in clear violation of the requirements of IFRS and the Framework, as highlighted in the preceding paragraphs. Resultantly, the 'shareholders' equity' and 'non-current assets' in the Accounts of the Company were misstated by 69% and 245%, respectively and the amounts of misstatements were material. It was responsibility of the respondent to appropriately modify his opinion in report to members, to discharge his duties under the Ordinance, the Rules and ISAs. However, the respondent issued a clean

report without any modification to highlight the non-compliance. It has been stated by the respondent that the mistake was inadvertent and has not caused any loss to any shareholder of stakeholder. It must be kept in mind that the financial statements are used by a variety of users including the shareholders, bankers, financiers, investors, potential investors and general public etc. The audited financial statements along with auditor's report are the most important source of financial information for the users who rely on the information disclosed therein. Any misstatements or omission of material facts in the financial statements can adversely affect the decisions of the users. Therefore, the plea that no loss has been caused to anyone, is cannot be absolutely true.

h) As per the requirements of the Ordinance, Rules and ISAs it is auditor's duty to appropriately modify the opinion to bring out all material facts about the affairs of the Company. Since the Accounts were materially misstated, therefore, appropriate modification of the audit opinion was imperative. Section 255 of the Ordinance prescribes powers and duties of the auditors and also sets the format of auditors' report. In terms of section 260 of the Ordinance, it is duty of the auditor to bring out all material facts about affairs of the Company in his report to members. In the instant case, the respondent in his capacity as engagement partner of the Auditor has not discharged his duties as per requirements of the Ordinance, Rules and the ISAs, as explained above.

9. Before proceeding to decide the matter, 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

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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.

10. For the foregoing reasons, I am of the view that the Auditor in his report to members on Company's Accounts for the year ended June 30, 2015 did not appropriately modify the opinion to highlight the incorrect accounting treatment adopted by the Company by recognizing 'discount on issue of shares' as a deferred cost. Hence, the Auditor's report failed to bring out material facts about the affairs of the Company and it was not in conformity with the requirements of section 255 of the Ordinance. However, considering the acquiescence of default and assurance for future compliance by the respondent, instead of imposing fine, I take a lenient view and in exercise of power conferred by section 260 of the Ordinance conclude the proceedings against the respondent with a stern warning to him be careful in future.

Abid Hussain
Executive Director

Announced:
June 9, 2016
Islamabad