



**SECURITIES & EXCHANGE COMMISSION OF PAKISTAN**

**NIC Building, Jinnah Avenue, Blue Area, Islamabad**

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**BEFORE APPELLATE BENCH NO. III**

In the matter of

**Revision No. 38 of 2003**

Muhammad Maqsood F.C.A  
3<sup>rd</sup> Floor, 39 Sadiq Plaza  
Shahrah-e-Quaid-i-Azam  
Lahore .....

Petitioner

Versus

Executive Director (EMD) SEC .....Respondent

Date of Impugned Order

June 30, 2003

Date of Hearing

December 22, 2003

**Present:**

For the Petitioner

Mr. Muhammad Maqsood. F.C.A

For the Respondent

1. Mr. Ashfaq Khan (Director) EMD
2. Ms. Wajiha Farooqi (Assistant Director) EMD

## **ORDER**

This order will dispose off the revision petition No.38 of 2003 filed under section 477 of the Companies Ordinance, 1984 by Mr. Muhammad Maqsood, FCA against the order dated June 30, 2003 (the "Impugned Order") passed by the Executive Director (Enforcement & Monitoring).

1. Brief facts leading to this revision petition are that the Executive Director (EMD) imposed a fine of Rs.4,000 on Mr. Muhammad Maqsood FCA under sub-section (1) of section 260 of the Companies Ordinance, 1984 (the "Ordinance") for not complying with the provisions of Section 255 of the Ordinance while making out Audit report to the members of Taj Textile Mills Limited (the "Company") on the Financial statements of the Company for the years ended September 30, 1998 and 1999. The auditors failed to report, among other matters, that the company did not disclose assumption/adoption of short-term borrowings of Rs.246.85 million relating to its associated unlisted company, Elahi Enterprises, as required by 4<sup>th</sup> Schedule to the Ordinance and applicable International accounting standards. The Executive Director (EMD) held that the Petitioner had not conducted the audit in accordance with the applicable auditing standards and his statements and representations in the audit reports for the years ended September 30, 1998 and 1999 were false and misleading. Aggrieved by the Impugned Order, Mr. Muhammad Maqsood has preferred this revision petition, which was initially fixed for hearing on October 22, 2003. However no one appeared before the Bench on the said date. The Bench re-fixed the case for December 22, 2003 to give the Petitioner another opportunity of hearing. The case was finally heard on December 22, 2003, when Mr. Maqsood himself appeared before us.

2. Mr. Maqsood contended that the Impugned Order was against the law and facts of the case and should be set aside. He argued that analogy of one case cannot be extended in another penal proceeding as the Executive Director has done in the Impugned Order. He stated that the audit conducted by Mr. Suleman Zahid FCA, to which the Executive Director (EMD) has referred to in his Impugned Order had nothing to do with him as it related to year ended 2001. He contended that the observations in respect of audit sampling made in

the Impugned Order were wrong and misleading as audit sampling is not prohibited under the law. He stated that the making of disclosure as to the existence and identification of related party was the duty of the management of the Company and if the management for any reason fails or declines to disclose, then the auditor cannot be held liable. He stated that the alleged agreement between the Company and the related party was never brought to his notice. He argued that in light of these facts it was clear that the default was not committed knowingly or willingly and at best could be regarded as an omission.

3. Mr. Ashfaq Ahmed, Director (EMD) appearing on behalf of the Executive Director (EMD) stated that the Petitioner was the engagement partner and signatory of the audit reports for the years ended September 30, 1998 & 1999. M/s Zahid Jamil & Co., Chartered Accountants of which the Appellant was a partner had been the auditors of the Company since its incorporation on March 24, 1986. They were also the auditors of one of the associated undertakings of Elahi Enterprises (Private) Limited. The annual Financial statements of the Company for the year ended September 30, 2001 revealed that short-term borrowings of Rs.246.853 million had been transferred to the Company from Elahi Enterprises. The aforesaid Financial statements did not provide any further information in respect of the transfer of huge amounts of loans from Elahi Enterprises. He stated that the Company had sustained losses of Rs.210.887 million during the year ended September 30, 2001 and its financial charges escalated by 166% in the second half of the aforesaid year and unsecured local trade debts increased by 280% over the last year. He stated that the audit reports for years ended September 30, 1998 & 1999 were signed by Mr. Maqsood FCA, which is an admitted fact. He further contended that a single show cause notice was issued in the matter to all partners of the Audit firm for same default relating to 4 years from 1998 to 2000, however due to the fact that the matter relating to Mr. Maqsood was delayed as he had requested for more time from the Executive Director (EMD), a separate order was issued in case of Mr. Maqsood. He stated that it was therefore wrong for Mr. Maqsood to argue that his case was separate from Mr. Suleman Zahid and an analogy to that order could not be made by the Executive Director (EMD).

4. On the issue of audit sampling, Mr. Ashfaq stated that the Petitioner has not given a single evidence of the steps he took to identify the related party's transactions and their treatment in the Financial statements. The Petitioner did not provide to the Commission its working papers required to see why the Petitioner failed to notice such a material transaction and what were those so called sampling techniques employed during the audit. He contended that ignoring such a transaction of so material significance cannot be termed inadvertent negligence and was therefore intentional. He stated that it was not clear how such an erroneous and allegedly negligent mistake could happen continuously for number of years. He referred to ISA 550 which specifies many steps that an auditor should perform before reaching on a conclusion.

5. We have heard both the parties and considered their arguments. As the Petitioner in his appeal has taken the plea that analogy of one case cannot be extended to another in penal proceedings, we have carried out a detailed review of the Financial statements and related audit reports for 4 years from 1998 to 2001 and records of proceedings by enforcement division for a judicious disposal of the case. The Enforcement Division of the Commission while examining the accounts of Taj Textile for the year ended 30.9.2001 noticed that company had recorded Short term borrowings of Rs.246.853 million as its liability (Note 7 to the Financial statements) and correspondingly increased its "Un-secured local Trade debts" by the similar amount (Note 16 to the Financial statements). Note 7.3 to Financial statements stated that, "*Short term bank borrowings also include bank credit facilities amounting to Rs. 246.853 million conveyed from Elahi Enterprises (pvt) Limited*" No further information was available in the said financial statements in this respect. The auditors issued an Unqualified Audit report on these Financial statements and audit report did not state specifically anything in relation to above.

6. On further examination of the Financial statements of Taj Textile, it was noticed that the company has suffered from a substantial loss of Rs.210.877 million during the year ended 30.9.2001 as compared to an after-tax profit of Rs.17.698 million last year despite the fact that its peers have made handsome profits during the year. Further, the financial charges of the company which averaged around Rs.135 million per annum for the last several years and stood

at Rs.158.587 million in the year 2000, escalated to Rs.245.775 million in the year 2001. Furthermore, a comparison of half yearly accounts for the period ended 31.3.2001 with the annual accounts for the year ended 30.9.2001, revealed that the company incurred financial charges of only Rs.67.206 million for the first six months of the year whereas financial charges of Rs.178.568 million were booked for the last six months of the year indicating an increase of 166%. Similarly, there was an abnormal increase on account of un-secured local trade debts which rose substantially from Rs.68.883 million as on 30.9.2000 to Rs.262.040 million as on 30.9.2001. Translated as percentage, the increase in unsecured local trade debts amounted to 280% during the year 2001. The Enforcement division took up the issue with the company and its auditors to explain the reason for not reporting the assumption of loans by the company which actually belonged to Elahi enterprises.

7. The information, explanation and records provided by the company and its auditors further revealed the following:-

- (i) M/s. Elahi Enterprises is an associated undertaking of Taj Textile as evident from composition of Board of Directors Of both companies consisting of common directors.
- (ii) The loans of Rs.246.853 million payable by Elahi Enterprises to its various bankers were assumed by Taj Textile during the years 1998 to 2001. This assumption of liabilities of Elahi enterprises by Taj Textiles was reportedly made under the pressure of the bankers of Elahi Enterprises who felt un-secured because of absence of significant asset base of Elahi Enterprises, which is evident from the minutes of the board of directors' meeting of Elahi Enterprises Ltd dated April 20, 1998, June 26, 1999, October 18, 1999, February 3, 2000 and January 2, 2001 and board of directors of Taj Textile Mills Ltd dated February 23, 1998.
- (iii) The aforesaid loans taken by Elahi Enterprises from the financial institutions were secured by personal guarantees of its directors, who were also directors of Taj Textile.

- (iv) Loan obligations were transferred through an agreement executed on April 22, 1998 between Taj Textile and Elahi Enterprises for the transfer of loans of Rs.246.853 million and payment of financial charges thereon by Taj Textile. On the basis of this agreement, transactions were recorded in the books of accounts of Taj Textile wherein loans payable to financial institutions of Elahi Enterprises were treated as liability of the company and corresponding asset account was created as receivable from Elahi Enterprises.
- (v) M/s. Taj Textile has been bearing financial charges on the loans unfairly transferred from Elahi Enterprises since 1998 and according to the Chief Financial Officer of Taj Textile; financial charges of Rs.53.086 million have been paid by Taj Textile since 1998 in regard to loans transferred from Elahi Enterprises.
- (vi) The company did not disclose the transactions and related asset and liabilities in its Financial statements for 3 years from 1998 to 2000. The asset receivable account and Short term loan obligations account created in General ledger of the company as a consequence of above transaction were closed at the closure of each financial year from 1998 to 2000 through offsetting these accounts by passing contra entries.
- (vii) The auditor gave the company an unqualified report with out giving any reference to the above transactions.
- (viii) Despite repeated requests by the enforcement division, none of the auditors of Taj Textile provided any working papers to demonstrate procedures undertaken by them to conduct of audits of Taj textiles for these years.

8. Executive Director (EMD) proceeded under section 476 of the ordinance and held auditors in default in complying with the provisions of sections 255 and 260(1) of the Ordinance through his orders dated April 29, 2003 and June 30, 2003 against Mr. Salman Zahid, FCA and Mr. Mohammad Maqsood respectively. A fine of Rs 4000 each was imposed on Mr. Salman Zahid and Mr.

Mohammad Maqsood for 2 years each for making out reports on Financial statements of the company other wise than in conformity with the Ordinance, making out untrue and false statements, and failure to bring material facts about affairs of the company. Mr. Salman Zahid appealed before the appellate bench against Executive Director's (EMD) Order dated April 29, 2003 which was rejected by the appellate bench and the said order was up held.

9. What we infer from our detailed review of information available on record and after hearing the arguments of the Petitioner and Enforcement division's representatives is that in 1998 M/s Taj textiles assumed the liabilities of its associated company Elahi enterprises unfairly and against the business interest of the company and concealed this transaction completely for 3 years from 1998 to 2000. The information was first reported and a limited inadequate disclosure was given in the Financial statements for the year ended September, 2001. Auditors during all these years, from 1998 to 2001 did not give any reference to this issue in their Auditor's report. The core issue to determine for disposing off this Revision petition judiciously is the Auditor's Scope, objective and professional responsibilities in relation to performing an audit of the Financial statements and his conclusion thereupon. Section 255 of the Ordinance, Auditors report (form 35-A) and International standards on Auditing as adopted by the Institute of Chartered Accountants of Pakistan govern the objective, scope, conduct and procedures to be applied essentially, and level of assurance required from the auditor on the truth and fairness or otherwise of the Financial statements. Section 255 of the Ordinance requires company's statutory auditor to make a report giving his opinion based on his thorough review and examination of the records, explanation and information of the company, among other matters, whether proper books of accounts as required by the Ordinance have been kept, whether Financial statements have been drawn up in conformity with the Ordinance and in agreement with books of accounts and whether Financial statements give true and fair view on the company's profitability and its state of affairs. Auditing standard-1 "Objective and General principles governing an Audit of Financial statements" which governs all other auditing standards provides, "*the objective of an audit of Financial statements is to enable the auditor to express an opinion whether the*

*financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The phrases used to express the auditor's opinion are "give true and fair view"*". This standard requires the auditor to plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the Financial statements to be materially misstated. This standard also requires auditor to apply professional competence and due care while performing his audit as part of his professional responsibilities. The above governing legislation and standards imply that the statutory auditor of a listed company has legal obligation to ensure to his satisfaction that Financial statements of the company exhibit true and fair view on company's profitability and its state of affairs and that company's books of account have been kept as required by law. International standards on Auditing, then, provide the frame work and procedures to be adopted to achieve this objective by gathering sufficient appropriate evidence enabling him to support his audit conclusion. Considering the materiality and related financial impact of the transactions under question, it is hard to believe that the auditor could not identify the transactions under question in spite of applying necessary procedures to obtain sufficient appropriate evidence to reach his Audit conclusion. It is an admitted fact that the transactions in question were appearing in the ledgers of the company, were discussed in detail in board of directors minutes and even resultant financial charges had been booked by the company on assumption of liabilities of Elahi Enterprises. Had the auditor applied basic audit and analytical procedures, reviewed minutes of board of directors' meetings and had questioned the rising trend in financial charges, the facts would have come to light. It appears that either auditor did not bother to perform basic tests involved in audit or they were party to the whole scheme for unethical and unfair transfer of associated company's liabilities to the company. The auditor failed to perform his duties with reasonable care , professional skill and caution. The courts have internationally held in various cases that Auditor has a duty to conduct his audit with skeptic attitude, reasonable care and caution. Lord Lopes L J held in *Re Kingston Cotton Mill* that , " It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would

use.” Lord Denning in the case of *Fomento(Sterling Area)Ltd v Selsdon Fountain Pen Co Ltd 1958* defined the auditor’s proper approach to their work by saying, “they must come to it with an inquiring mind-not suspicious of dishonesty –but suspecting that someone may have made a mistake and that a check must be made to ensure that there has been none.” But, in the instant case, the auditor did not provide any evidence to prove that he applied all necessary procedure to ensure that financial statements were free from any material error.

10. As for ground no. 3 taken by the petitioner that he had honestly applied the tests prescribed by Auditing standard 19-Audit sampling and Other selective Testing procedures, we reviewed ISA 19 which stipulates in its very beginning in Para 2. , “ When designing audit procedures, the auditor should determine appropriate means for selecting items for testing so as to gather audit evidence to meet the objective of audit tests”. This means that the purpose of audit sampling is to gather audit evidence to meet the objectives of audit tests. Now looking at the purpose of audit evidence, we reviewed Auditing standard 8- Audit evidence which requires in its Para 2, “The auditor should obtain sufficient appropriate evidence to be able to draw reasonable conclusions on which to base the audit opinion”. and Auditing standards-1- Objective and General principles governing an Audit of Financial statements which governs all other auditing standards provides, “the objective of an audit of Financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The phrases used to express the auditor’s opinion are “give true and fair view”. By reading the above reference of Auditing standards together, we infer that the International standards on Auditing require auditor to plan and execute his audit using procedures which provide him sufficient appropriate evidence to reach his audit conclusion as to the trueness and fairness or otherwise of Financial statements under review.

11. As for petitioner last ground relating to his inability to identify related parties and related party transaction when management did not disclose the same. We are unable to comprehend as to how auditor would have omitted

identification of transactions of such nature, magnitude and grave financial impact. The auditor just needed to review the minutes of Board of Directors and he would have identified the whole scheme of these transactions and issues involved. Further, the fact that the same audit firm is also the auditor of Elahi enterprises makes it impossible for the auditor not to identify the related party relationship between the two companies who had common directors on their Board of Directors.

12. This is a classic case of hiding transactions by the company with its associated company by not reporting the same in its Financial statements over several years. The transaction had no basis – Assumption of huge liabilities with no corresponding tangible assets in exchange is like making complete irony of business and accounting principles. The management of company concealed the transactions from its shareholders by wrongly off-setting the corresponding asset and liability accounts with the intent to defraud the readers of Financial statements. And it is hard to believe considering the nature, magnitude and financial impact of the transactions that the same could be done without connivance of auditors. In our view, this case is strong candidate for proceedings under subsection (2) of section 260 of the Ordinance. E.D. (Enf) opted to proceed under section 260(1) holding auditor negligent in performing his audits of the company which already is a fairly lenient treatment of the defaults involved.

13. In light of the submissions of the parties and the above findings, the order of the Executive Director (Enforcement & Monitoring) dated June 30, 2003 is hereby upheld. This Revision is dismissed accordingly.

**(ETRAT H. RIZVI)**  
Commissioner (SCD)

**(M. ZAFAR UL HAQ HIJAZI)**  
Commissioner (PSP)

Announced in Islamabad on December 31, 2003