Appellate Bench Orders

Before Appellate Bench No.3

November 07, 2002

Before Appellate Bench No. 3

In the Matter of

Appeal No. 42 of 2002

1. Mr. Ahmed D Patel
2. Mr. Salim Chinoy
3. Mr. Mustafa Khandwala
4. Mr. Majid Khandwala
5. Mr. Pervez Muslim
6. Mr. Aqeel E. Merchant
7. Mr. Asim Siddqiui
8. Mr. Ejaz Ahmed
9. Mr. Muhammad Junaid
10. Mr. Tariq Jameel

All partners of Ford, Rhodes, Robson, Morrow
Chartered Accountants
1st Floor, Finlay House
I.I Chundrigar Road, Karachi

11. Ford, Rhodes, Robson, Morrow
Chartered Accountants
1st Floor, Finlay House
I.I Chundrigar Road
Karachi ..... Appellant

Versus

Executive Director (SC) SEC ..... Respondent

Date of Impugned Order May 27, 2002

Date of Hearing October 02, 2002

Present:

For the Appellant

1. Mr. Salim Chinoy
2. Mr. Ahmed D. Patel
3. Mr. Mehmood Mandviwalla, Counsel

For the Respondent

1. Ms. Irum Butt, Director
2. Ms. Jaweria Ather, Joint Director
3. Mr. Asif Bhatti, Deputy Director

Order

This matter arises before us from an appeal filed by the Appellants against the order dated May 27, 2002 (the "Impugned Order") made by the Executive Director (Specialized Companies) pursuant to a show cause notice under section 255 read with section 260 of the Companies Ordinance, 1984. Brief facts leading to this appeal are as follows:

1. M/s. Ford, Rhodes, Robson, Morrow, Chartered Accountants (hereinafter referred to as FRRM), having their head office at Finlay House, I. I. Chundrigar Road, Karachi, were appointed by Pakistan Industrial & Commercial Leasing Limited (hereinafter referred to as the "Company"), having its registered office at 504, Park Avenue, 24-A, Block 6, P.E.C.H.S., Karachi, as its statutory auditors under section 252 of the Companies Ordinance, 1984 (hereinafter referred to as the "Ordinance").

The Securities and Exchange Commission of Pakistan (hereinafter referred to as the "Commission") appointed a Special Auditor, M/s. Ibrahim, Shaikh & Co., Chartered Accountants, under rule 19 of the Leasing Companies (Establishment and Regulation) Rules, 2000 to conduct a special audit of the Company for the year ended June 30, 2000. Rule 19 (2) of the Leasing Companies (Establishment and Regulation) Rules 2000, which empowers the Commission to appoint a Special Auditor provides: -

"The commission shall monitor the general financial condition of a leasing company, and, at its discretion, may order a special audit and appoint an auditor to carry out detailed scrutiny of the affairs of the company…"

2. The Special Auditor, inter alia, reported that an amount of Rs. 37.092 million had been siphoned out of the Company through fake leases to M/S Alpine International (Pvt.) Limited (hereinafter referred to as "AIL") and M/S Mehran Animal & Poultry Feeds (Pvt.) Limited (hereinafter referred to as "MAPFL"). On the basis of the special audit report, the Respondent inquired from FRRM, vide letter dated August 6, 2001, as to why no apprehension regarding fake leases, given by the Company to AIL and MAPFL, was reported in the Auditors' Report for the year ended June 30, 2000.

3. FRRM, through its letter dated August 31, 2001, replied that lease facilities to AIL and MAPFL did not appear to be fictitious on the basis of documentation and representations provided by the management during the course of the statutory audit. On January 16, 2002, a show cause notice was issued to FRRM by the Respondent to explain why a penalty may not be imposed under section 260 of the Ordinance. FRRM submitted its explanations vide its letters dated January 28, March 8, April 22 and April 29, 2002. Duly authorized representatives of FRRM also appeared before the Respondent for a hearing on

April 17, 2002. The Respondent not being satisfied by the explanations provided by FRRM imposed a fine of rupees two thousand on each of the partners of FRRM (Appellants numbered 1 to 10 herein) vide the Impugned Order under sub-section (1) of section 260 of the Ordinance for willful default in failing to carry out its duties as statutory auditors of the company.

4. Aggrieved by the Impugned Order, the Appellants have preferred this appeal before this Bench. The case was fixed for hearing on October 02, 2002 and the parties appeared and argued the case. It is the case of the Respondent that FRRM, being the statutory auditors of the Company, failed to bring out material facts about the affairs of the Company in the Auditors' Report in violation of the provisions of the Ordinance.

5. The main contentions of the Respondent are that FRRM failed to detect or obtain reasonable assurance about the peculiar circumstances of lease transactions with AIL and MAPFL, including the following: -

(a) the sale and leaseback arrangements with AIL and MAPFL were made on June 25, 1999 and December 10, 1998 respectively. The machinery, which was the subject of these sale and lease back agreements, was neither available with nor owned by any of the parties involved, i.e. AIL, MAPFL and the Company, at the time of entering into the agreement;

(b) amounts of Rs. 28.092 million and Rs. 9 million were disbursed by the Company to AIL and MAPFL on 1.7.1999 and 30.6.1999 respectively. No payment was made by the Company to the supplier for acquisition of machinery; rather the entire lease money was paid directly to AIL and MAPFL;

(c) the legal title or physical possession of the machinery had not been transferred to either the Company, AIL or MAPFL by June 30, 2000. Till the time the audit for the year ended June 30, 2000 was concluded, the machinery was lying at port, in the case of AIL, and at the supplier's warehouse, in the case of MAPFL. The ownership of the machinery was also with the supplier, M/s. Johar Associates. The company made payments to AIL and MAPFL on the basis of invoice of M/s. Pak Europe Engineering. The payment made by the company represented only 60% of the invoiced price in both cases. Thereby meaning that the balance 40% price had been either paid already or was payable in future by AIL and MAPFL to acquire the ownership to be able to sell the same to the company.

6. Mr. Mehmood Mandviwalla the learned counsel for the Appellants appeared before the Bench along with Appellants and argued the case on behalf of all the Appellants. The contention of the Appellants is that FRRM had performed their duties as statutory auditors of the Company with due care and diligence in examining the documents in connection with the audit of the company conducted by them for the year ended June 30, 2000.

7. FRRM has asserted that it relied on relevant documentation in support of the sale and lease back transactions between the Company and AIL and MAPFL. These documents included board approvals, lease agreements, sale agreements, purchase invoices, valuation reports and receipt of lease payments.

FRRM further asserted that in the presence of such documents and information, FRRM as the auditors of the Company was not obliged to investigate any further on the basis of any speculation or conjecture.

8. We have heard both the parties at length and have considered their arguments. In our opinion, the crucial issue involved here is whether, on the basis of the documents and information available to FRRM during the conduct of the audit, FRRM could reasonably conclude that the sale and leaseback transactions between the Company and AIL and MAPFL were in fact genuine. For in our opinion if the documentary evidence available did not lead to this conclusion then there was a duty cast upon FRRM to corroborate the evidence through other audit procedures.

9. It is the contention of FRRM that examination of sale and leaseback agreements of AIL and MAPFL did not reveal any such discrepancy which could lead to the reasonable conclusion that the leases were not genuine. The Respondent in turn contends that FRRM failed to take into cognizance the fact that no machinery existed at the time these agreements were made.

10. A sale and lease back agreement is, in substance, a simultaneous sale of an asset to the leasing company, which becomes the owner and grants the right of use to the seller (who ceases to be the owner) for agreed rentals and for an agreed period of time. In the case of AIL and MAPFL, the Company disbursed the purchase price without the asset being there and therefore right of use of a non-existent asset remains a questionable issue.

11. Learned Counsel for the Appellants has contended that under the provisions of the Sale of Good Act, 1930 (the “SGA”) the goods which form subject of a contract of sale may be either existing or future goods. Although this contention is correct, however a simple contract for sale is different from a sale & lease back agreement. The combined effect of the sale & lease back agreement is that of a purchase of an existing asset and simultaneous right of use given to the seller who no more remains an owner of the asset and thus starts paying a rental for the use of asset previously owned by him.

12. Sub-section (3) of Section 4 of the SGA lays down: -

“Where under a contract of sale the property in the goods is transferred from the seller to the buyer, the contract is called a sale, but where the transfer of the property in the goods is to take place at a future time or subject to some condition thereafter to be fulfilled, the contract is called an agreement to sell.”

Sub-section (3) of Section 6 of SGA further specifies that: -

“Whereby a contract of sale the seller purports to effect a present sale of future goods, the contract operates as an agreement to sell.”

The agreements between the Company and AIL and MAPFL were therefore, agreements to sell and not contract of sale as the assets were neither in deliverable state nor specific, nor identifiable. Hence, the payments made by the Company could not be treated as sale & lease back transactions.

13. FRRM has not mentioned whether the Company produced any document at the time of audit which could verify AIL's and MAPFL's ownership to the assets before the title could be transferred to the Company vide the sale agreements. Further, the Bench inquired from the Appellants whether a Letter of Credit had been opened by AIL and MAPFL for the assets. Mr. Ahmed D. Patel replied that he was not sure.

14. It is to be noted that FRRM in its letter to the Board of Directors of the Company dated December 02, 2000 commenting on the leases with AIL and MAPFL had stated that:

"Further, the sale and lease back transaction has been entered into without the physical existence of leased assets as the same were imported after the amount was disbursed to the lessee."

15. Learned counsel for the Appellants contended that the 'legal' title to the assets passed from AIL and MAPFL to the Company upon the execution of the sale and leaseback agreements. It is a well-known principle that "no one can transfer a better title than he himself possesses". AIL and MAPFL therefore, could transfer the title to the assets to the Company only when they themselves possessed it.

16. SGA does recognize a sale by person who himself is not the owner of the goods, however as we have mentioned above, in our opinion sale & lease back agreements do not come within the scope of the SGA. Besides even under the principles of sale of goods where goods are sold by a person who is not the owner of the said goods and who does not sell them under the authority or with consent of the owner, the buyer acquires no better title to the goods than the seller had.

17. The fact is that the machinery was not owned by AIL and MAPFL at the time when the sale & lease back agreements were executed and in our opinion the supplier's invoices on which FRRM has relied make that fact obvious. There is a clear contradiction therefore, between these two documents on which FRRM has admittedly relied upon. A contradiction, which was not pointed out by FRRM in the report.

18. The invoices issued by M/s Pak Europe Engineering indicated that the delivery of assets to AIL and MAPFL would be made in November / December 2000 however, no delivery schedule was attached with the invoices. Moreover the Packing List dated September 21, 2000 on which FRRM has admittedly relied and the Bill of Lading dated September 22, 2000 were in the name of M/s. Johar Associates (the supplier) who was the real owner of the machinery. Also, in our opinion the fact that invoices supplied by both AIL and MAPFL were from the same supplier, namely Pak Europe Engineering, should have also cast doubt on the transactions.

19. The documents therefore, did not provide evidence as to whether or not ownership of machinery had been transferred in the name of the Company by June 30, 2000. No machinery was transferred in the name of the Company by the time the audit report was signed, i.e. December 05, 2000.

20. Further, FRRM was also aware that the assets had not been imported by AIL and MAPFL by the balance sheet date. In such a case where physical possession of assets had not been transferred, it was essential for FRRM to substantiate transfer of legal title and not rely only on examination of invoices.

21. FRRM has also submitted that Razzaq Umerani & Co. did not indicate at the time of valuation that the machinery was in fact owned by the supplier and not by AIL or MAPFL. However, we agree with the contention of the Respondent that a valuer is engaged to provide a reasonable estimate of the value of the asset and not to certify the ownership of the asset as well. While Razzaq Umerani & Co. did not correctly reflect ownership of machinery in valuation reports issued on November 27, 2000, FRRM could not solely rely on these unqualified valuation reports in drawing a conclusion on ownership of assets. In our view inspection of the machinery in question on November 25, 2000 by FRRM representative did provide reasonable opportunity to determine ownership of assets.

22. The Appellants along with the supporting documents submitted a chronology of events, which was considered by the Bench. This chronology itself reveals that the date of sale & lease back agreements in case of AIL is June 25, 1999, whereas the invoice on which FRRM has so heavily relied upon is dated June 28, 1999. In case of MAPFL, the date of sale & lease back agreements is December 10, 1998, whereas the invoice is dated June 29, 1999. This means that the sale and leaseback agreement was signed on December 10, 1998 in anticipation of an invoice to be received six months later i.e. on June 29, 1999. In both these cases payment by the Company to AIL and MAPFL were made on July 01, 1999 and June 30, 1999. It is quite clear that at the time when the sale & lease back agreements were entered into by the Company, AIL and MAPFL had not even placed orders for the assets. How could they have then sold the assets to the Company and alongside leased them back in such circumstances is not explainable. FRRM failed to point this anomaly out in their audit report.

23. The Bench inquired from the Appellants as to what would be considered as fake leases in their opinion. The learned counsel suggested that a transaction where there were no underlying assets, or no re-payments are made or the seller is not identifiable should be considered fake. We consider this definition correct and note that this definition fits the present case.

24. Another major violation by the Company, which in our opinion should have caste reasonable doubts on the whole transaction was the arrangement whereby payment was not disbursed to the supplier but was paid directly to AIL and MAPFL. Article 8.01 of the lease agreements between the Company and AIL & MAPFL clearly stipulate that,

“in the event of the lessee selecting equipment / machinery which is to be imported, PICL shall be only responsible to make payment therefore to the supplier/manufacturer.”

25. It was submitted by FRRM that since the Hon’ble High Court had passed the decree against AIL on the basis of same documentation on which FRRM had relied during the course of its audit, it proved that lease and leaseback transaction with AIL was not fictitious. FRRM argued that the decree passed by the Hon’ble High Court confirmed Company’s ownership of the leased assets. At

the outset the judgment passed by the Hon'ble High Court reveals that no leave to defend was filed by AIL and consequently the decree was passed ex-parte. Also, the purport of the Financial Institutions (Recovery of Finances) Ordinance 2001 as the name implies, is recovery of finances and advances made by the financial institutions. The decree does not establish ownership of the leased assets but only establishes a claim of the Company for recovery of the amount due from AIL as there is undeniable evidence that payment was made by the company to AIL. This argument is strengthened by the fact that the order of the High Court does not mention the right of repossession of the leased assets by the Company. In our opinion the Respondent has therefore, rightly concluded that a decree in favour of the Company does not mean that the sale and leaseback transaction with AIL was regular during the period under review by the auditors. In fact, FRRM had itself identified irregularities and had mentioned the same in the management letter dated December 2, 2000 particularly the absence of leased assets as of the date of management letter. It is also pertinent here that FRRM relied among other things on the sale invoice of M/s Pak Europe Engineering whereas Packing list dated September 21, 2000 and the Bill of Lading dated September 2000 were in the name of M/s. Johar Associates. The invoice issued by AIL and MAPFL to the company were, therefore, without the assets being either in the possession or the ownership of AIL and MAPFL.

26. As mentioned above, FRRM submitted that it had brought certain irregularities in the leases to the notice of the Board of Directors of the Company through its letter of December 02, 2000 and the Chief Executive was instructed by the directors to regularize the matters. FRRM submitted that it relied on verbal communication with the management in respect of explanations furnished by management in response to its letter dated December 02, 2000, as the minutes of this meeting were not finalized until December 21, 2000 and the audit report was signed by FRRM on December 05, 2000. It was the contention of the Respondent that reliance placed by FRRM on management representations coupled with its failure to obtain written representations before issuing the audit report did not reflect well on the professionalism of FRRM in this regard.

27. Although reliance on verbal representations of the management of the Company may be the case in usual circumstances, we are of the view that there were sufficient grounds as given in paragraphs 17 to 25 of this order for FRRM to cast an opinion that the payments by the Company to AIL and MAPFL did not constitute sale and leaseback transactions even till the time of signing the Audit Report (Almost 17 months after the payment).

28. We have heard the arguments by the parties and have seen the documents on record and are of the opinion that FRRM could not reasonably conclude on the basis of the documents and information available to them during the conduct of the audit, that the sale and leaseback transactions between the Company and AIL and MAPFL were genuine. There was a responsibility on FRRM in the interest of the shareholders of the Company to corroborate the evidence through other audit procedures, which responsibility they failed to discharge. FRRM therefore could not have stated in their report as required by section 255 of the Ordinance that the accounts of the Company had been drawn up in accordance with the requirements of the Ordinance and give a true and fair view of the Company's affairs.

29. In light of the submissions of the parties, examination of records and the above findings, this Bench upholds the order of Executive Director (Specialized Companies) dated May 27, 2002.

(M. ZAFAR-UL-HAQ HIJAZI)
Commissioner (Company Law)

(ETRAT H. RIZVI)
Commissioner (Insurance)

Islamabad
Announced: November 07, 2002