



BEFORE APPELLATE BENCH NO. III

In the matter of

Appeal No. 4 of 2005

1. Hyder Ali Bhimji, FCA

3. Shaik Mohammad Tanvir, FCA

2. Muhammad Hanif Razzaq, FCA

4. Syed Aftab Hameed, FCA

All Partners of
Hyder Bhimji & Co.
Chartered Accountants
Standard Insurance House
I.I Chundrigarh Road
Karachi

Appellants

Versus

Director (Enforcement II)Respondent

Date of Impugned Order

February 09, 2005

Date of hearing of appeal

May 17, 2005

Present:

Munawar Salam Advocate, S.M Tanveer & Syed Aftab Hameed for the Appellants

Uzma Hayat Joint Director and Ayesha Riaz Assistant Director for the Respondent



ORDER

1. This appeal No.4 of 2005 has been filed under section 33 of the Securities and Exchange Commission of Pakistan Act, 1997 by Hyder Ali Bhimji FCA, Muhammad Hanif Razzaq FCA, Shaik Mohammad Tanvir, FCA and Syed Aftab Hameed, FCA who are all partners in Hyder Bhimji & Co. Chartered Accountants against the order dated 09-02-2005 passed by Director (Enforcement II).

2. Brief facts of the case are that Hyder Bhimji & Co. had conducted the audit of the accounts of Tristar Power Limited ('Company') for the year ended 30-06-2002. The audit report was signed by the auditors on April 18, 2003. The examination of the said accounts of the Company by the Enforcement Department revealed the following deficiencies and irregularities.

(i) Going Concern Assumption

The Company is a captive power project and is engaged in generating, distributing and supplying electricity to its associated undertaking Tri Star Polyester Limited (TPL). The Company's ability to continue as a going concern was reportedly dependent on its sole Client's ability to continue as a going concern and the TPL was in financial and operational distress. The Company had suspended its operations since 2001, its accumulated losses stood at Rs.32.296 million and it had a negative cash flow during the year. Directors had not given any prospect for the revival of the Company in their report to the members. These circumstances gave rise to significant doubt regarding the Company's ability to continue as a going concern. The Company had not explained the appropriateness of using Going Concern



assumption in preparation of the Accounts and the Auditors failed to modify the opinion regarding validity of going concern assumption as per Auditing Standards, as applicable in Pakistan;

(ii) Impairment of Investment

The Company had not made provisions for impairment against investments amounting to Rs.36.700 million in its associated company Tristar Energy Limited considering the fact that it had not started its commercial operations and the Commission had filed a petition for winding up of Tristar Energy Limited on 08-12-2000. The Auditors failed to modify their opinion in audit report on the accounts of the Company for the year ended 30-06-2002 in this regard.

(iii) Verification of Assets

Income Tax authorities seized the record of the Company in 1996 and since then Company did not maintain Fixed Assets Register. Note 4.2 of the financial statement for the year ending 30-06-2002 disclosed that Auditors had not been able to physically verify fixed assets of the Company valuing Rs.71.745 millions and note 5.4 disclosed that NIT Units amounting to Rs.34.595 millions were not in the custody of the Company. The auditors have just given matter of emphasis to the relevant notes and have stated in their report that proper books had been kept by the Company.

(iv) Disclosure Deficiencies

Company had not followed the disclosure requirements of the following International Accounting Standards and Fourth Schedule to the Ordinance:

- a. Disclosure of Staff Retirement benefits according to Para 120 of IAS -19 (Employee Benefits)



- b. Disclosure for shares held by associated undertaking in the share capital of the Company as required by Para 74 of IAS 1(Presentation of Financial Statements).
- c. Building shown in fixed assets had not been distinguished into building on leasehold or freehold land as required by Para 2 of Part II of 4th Schedule of the Ordinance.
- d. Disclosure regarding date, as to when the financial statements were authorized for issue, and who gave that authorization, had not been given as required by IAS 10 (Events after balance sheet date)
- e. Plant capacity for the year had not been given as per the clause (vii) of Para 2 of Part 1 of the Fourth Schedule to the Ordinance.
- f. Name and amount due from each associated undertaking was not disclosed (Note 7 to the accounts) as per Sub-clause (b) of clause C of para 6 of Part II of Fourth Schedule to the Ordinance.
- g. Purpose of reserve had not been given as per Para 74 (b) of IAS 1(Presentation of Financial Statements).
- h. Disclosure of Credit risk as per Para 66 of IAS 32 (Financial instruments: Disclosure and Presentation).
- i. Accounting policy relating to provisions was not given as required by Para 97 of IAS 1 (Presentation of Financial Statements); Moreover, the accounting policy on stores and spares was not correct as per IAS 2 (Inventories)

3. Consequently, a show cause notice dated 04-06-2004 was issued to all partners of Hyder Bhimji & Co. under section 260 read with section 255 of the Companies Ordinance, 1984 ('Ordinance'). After providing an opportunity of hearing, Director (Enforcement) imposed a fine of Rs.10,000/- each on all partners of Hyder Bhimji & Co., namely the Appellants under sub-section (1) of section 260 of the Ordinance for making a report otherwise than in conformity with the requirements of Section 255 of the Ordinance. He also sent the order to President, ICAP for his information and



necessary action in accordance with the provisions of the Chartered Accountants Ordinance, 1961. The Appellants have preferred the appeal against this order dated 09-02-2005 ('Impugned Order').

4. Mr. Munawar Salam Advocate along with Appellants No. 3 and 4 appeared before us on the date of hearing on behalf of all the Appellants. On the issue of going concern the Appellants stated that the Audit of the Company was started in March 2003 and the Audit Report was signed on 18-04-2003. At the time of the signing of the report both the Company and the TPL were in operation and there was no real issue of the going concern assumption. The Going Concern Review Checklist duly completed by the in-charge of the audit provided that there was no significant doubt regarding the going concern assumption. Besides the Company was in order and capable of generating electricity at anytime. The project was an equity financed project without any financial leverage hence there was no imminent risk of defaults of any nature and neither was there a risk of foreclosure.

5. On the issue of impairment of investment it was contended that the audited accounts of the investee Company were relied upon and that the same was also fully disclosed in the audited accounts of the Company. Mr. Salam contended that the Director failed to appreciate that the audited accounts of the company are independent third party evidence and the same can be relied upon in law. He argued that the Disclosure Deficiencies alleged against the Appellants were not material or other wise disclosed in the annual report of the Company. He argued that section 260 provides for a penalty only if 'material facts' about the affairs of the Company are not disclosed. He further argued that the penalty under section 260 could only be imposed if the default by the Appellants was willful, which it was not. He referred to different definitions and interpretations of the term 'willful' given by the superior courts. He contended that in its ordinary dictionary sense, the term willful means intentional or deliberate and not accidental or inadvertent. He stated



that the Impugned Order was not a speaking order and the Director had not given due consideration to the grounds and issues raised by the Appellants. He prayed that the Impugned Order be set aside.

6. Mrs. Uzma Hayat Joint Director appearing on behalf of Director (Enforcement) stated that the claim of the Appellants that the Company and the TPL were operational at the time of signing of the audit report was incorrect for the following reasons.

- That the going concern of the company was contingent upon the status of operation of its sole customer TPL. There were significant doubts about the status of operations of TPL also audited by the same auditors, in light of evident failure to comply with the statutory requirements of holding AGMs and submitting accounts before the shareholders for the years 2001. These facts were available to the auditors before signing of report. Financial statements of TPL for the year ended June 30, 2000 disclosed that against paid up capital of Rs.214.657 million, the accumulated loss was Rs. 206.843 millions and this loss would have further increased to the tune of 245.87 millions if depreciation would have been charged at normal rate of 10% as per practice in the previous years as stated by auditors in their audit report. Current liabilities of TPL increased over current assets by an amount of Rs. 187.820 millions.
- The effect of weak position of the client on the company were already evident from the financial statements of the company for 2001 when nil sales were shown, due to no power generation activity owing to nil demand

7. She argued that Para 26 of IAS 28 requires following disclosure in the investors financial statements with respect to its investments in associates:

In accordance with the requirements of IAS 37 (Provisions, contingent liabilities and contingent assets) the investor discloses:



- a) *Its share of contingent liabilities and capital commitments of an associate for which it is also contingently liable; and*
- b) *Those contingent liabilities that arise because the investor is severally liable for all the liabilities of its associate.*

In view of the above disclosure requirement it was important for the Appellants to obtain written representation from the management regarding pending petitions against its associate. The Appellants failed to obtain those. This consideration of obtaining written representation from the management is defined in Para 39 of IAS 8. A glance at the audited accounts for the year ended June 30, 2001 of Tri Star Energy Limited revealed that it had not commenced its operations after having been incorporated on October 19, 1994. The fact was itself sufficient to raise some doubts about the status of investment in such a company that has failed to commence its business after 7 years of its incorporation. It was further argued that the grounds that the disclosure deficiencies are not material or otherwise disclosed in the auditors report, do not hold true. Major weaknesses in audit coupled with lapses on account of disclosure requirements of the IAS cast doubts about the quality of audit, which amounted to failure in performance of a statutory duty. Thus provisions of Section 260 are attracted.

8. On the issue of the default not being willful, Mr. Ali Asad appearing on behalf of the Director referred to the decision of the Appellate Bench in the case of Shaikh Jalaluddin F.C.A vs. Commissioner (Enforcement) which was upheld by the Hon'ble High Court in appeal (judgment is unreported).

9. We have heard the arguments of both sides at length. We begin with the issue of willfulness. The case of Shaikh Jalaluddin F.C.A vs. Commissioner (Enforcement) is quite relevant to the issue at hand. There too 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 as follows.

*“ In the 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.”*

10. This reasoning given by the Bench was upheld by the Divisional Bench of the High Court in an appeal filed by the auditor in that case. We also subscribe to the view that if the auditor claims to know the law and the applicable auditing standards and also claims to have followed them then he cannot escape liability by simply saying that his default was not willful when he actually has not followed the law and the standards. We also do not agree with the contention of the Appellants that the Impugned Order is not a speaking order. As is apparent from the bare reading, the Director has passed a detailed and reasoned order which takes into account all issues raised by the Appellants.

11. On the issue of going concern we tend to agree with the finding of the Director that the Para 8 of IAS 23 gives examples which may cast significant doubt about the going concern. The loss of sole client should fall under the “loss of major market” and this should have raised concerns of the Auditors and accordingly they should have modified the report. The Company operations were dependent on the sole customer TPL and TPL was facing going concern issues itself. The Auditors were also fully aware of the affairs of TPL. The fact that the directors of the Company did not give any prospect of revival of the Company in their report



required auditor's attention. We also agree that the Appellants should have qualified their report on the issue of verification of assets. The fact that the Company did not maintain proper books and its assets were unverified for six years should be a reason for concern for the auditors appointed by the shareholders of the Company. Section 230(1)(c) requires that every company shall maintain proper books of accounts with respect to assets of the company. In this case this register was not there, and yet the Appellants stated in their report that the report was in accordance with the provisions of the Ordinance.

12. Similarly, the Appellants argument about disclosure requirements with regards to employees of the Company is without merits. Para 102(d) of IAS 1 clearly lays down the requirement on the auditor to disclose the number of employees. As also held in the case of Shaikh Jalaluddin F.C.A., the argument that disclosure of employees is not a material fact is unacceptable. The term 'materiality' has been defined in the IAS. It provides that, '*Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements*'. The fact that the company has no employees can and should influence the economic decisions of the users of the financial statements. Also, in our view there is a difference between not reporting something, and reporting that there is nothing to report. If there were no employees, the Appellants should have reported that fact, as they are required to do so, instead of not reporting anything. On the issue of building shown in fixed assets not been distinguished into building on leasehold or freehold land as required by Para 2 of Part II of 4th Schedule of Ordinance, the Appellants admitted their fault.

12. In our opinion the facts which were not disclosed by the Appellants in their report were material facts about the affairs of the Company. In the case of **London and General Bank Ltd. (1895) 2 Ch 166** it was observed by the court that, '*A person whose duty is to convey information to others, does not discharge that duty by simply giving*



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them, so much information as is calculated to induce them, or some of them, to ask for more. ...the duty of an auditor is to convey information, not to arouse inquiry and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement...'. Based on the grounds mentioned above, we are of the view that the Appellants have not made a report which is in conformity with the requirements of Section 255 of the Ordinance and therefore, uphold the Impugned Order. This appeal is dismissed.

(Shahid Ghaffar)
Commissioner

(Etrat H. Rizvi)
Commissioner

Announced in Islamabad on July 27, 2005