



**BEFORE
RECONSTITUTED APPELLATE BENCH NO.III**

In the matter of

Appeal No. 57 of 2003

Shaikh Jalaluddin F.C.A
Sandhu & Co. Chartered Accountants
State Life Building No.2, Wallace Road
Off I.I Chundrigar Road
Karachi Appellant

Versus

Commissioner (Enforcement & Monitoring) SEC.....Respondent

Date of Impugned Order September 19, 2003

Date of Hearing of Appeal May 13, 2004

Present:

Mr. Shaikh Jalaluddin F.C.A for himself

Ms. Sumaira Siddiqui, Deputy Director (EMD) &
Mr. Mubasher Saeed, Joint Director (EMD) for the Respondent



ORDER

This order will dispose off appeal No.57 of 2003 filed under section 33 of the Securities & Exchange Commission of Pakistan Act, 1997 by Mr. Shaikh Jalaluddin, FCA against the order dated 19-09-2003 (the “Impugned Order”) passed by Commissioner (Enforcement & Monitoring).

1. Brief facts leading to this appeal are that Mr. Inayatullah Sandhu and Mr. Sheikh Jalaluddin of Sandhu & Co., Chartered Accountants were the statutory auditors of Qayyum Spinning Limited (the ‘Company’) for the year ended 30-09-2000. A show cause notice dated 27-11-2002 was issued by the Commission to the auditors under Rule 17-A of the Companies (General Provisions & Forms) Rules, 1985 and sub-section (1) of section 260 read with sections 255 and 476 of the Companies Ordinance, 1984 (the “Ordinance”). The notice required the auditors to explain why penalty may not be imposed on them for preparing the audit report otherwise than in conformity with the requirements of section 255 of the Ordinance, and for failing to bring out material facts about the affairs of the Company. After providing an opportunity of personal hearing to the two partners, Commissioner (Enforcement & Monitoring) while holding that the disclosure requirements of International Accounting Standard (IAS) 1, 19, 32, & 33 were not followed, imposed a fine of Rs.1,000/- on Mr. Sheikh Jalaluddin under sub-section (1) of section 260 of the Ordinance on the following grounds:

- (a) the Appellant failed to disclose the number of employees of the Company in his report;
- (b) the Appellant failed to disclose the staff liability separately;
- (c) the Appellant failed to express an adverse opinion on the going concern assumption; and



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(d) the Appellant failed to modify the report so as to express a qualified, disclaimer or an adverse opinion.

2. Being aggrieved by the Impugned Order, Mr. Sheikh Jalaluddin filed this appeal before the Appellate Bench which was heard on 13-05-2004. Mr. Jalaluddin (the 'Appellant') appearing for himself pleaded that the Commissioner was not justified in law to form the opinion that he did not follow IAS 1, 19, 32 and 33. With regards to the disclosure of number of employees of the Company in his report, he contended that the Company did not have any employees at all and therefore he did not deem it necessary to make the disclosure. Similarly, as there were no employees, the staff liability was negligible and therefore there was no need for the disclosure. He stated that the staff liability in terms of gratuity was only a few hundred rupees, which was not material. He referred to sub-section (1) of section 260 which provides;

"260. Penalty for non-compliance with provisions by auditors.- (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.

3. He argued that under section 260 of the Ordinance, an auditor can be penalized only if he fails to disclose 'material facts', whereas the facts mentioned above were not material. He stated that he exercised his discretion in not reporting these facts. When enquired by the Bench whether the auditor has this discretion under the Ordinance and IAS, he argued that the Ordinance does not define the term 'material facts' and therefore it was left to the auditor to decide what material is.



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4. With regards to the issue of not expressing an adverse opinion on the going concern assumption, the Appellant argued that his entire audit report made that sufficiently clear about the Company. When asked by the Bench whether his final opinion contained that finding, he accepted that it did not. He however, argued that the finding of the Commissioner was that he did not express an opinion at all whereas he has done so in his report. Similarly, he claimed that his report was qualified as the entire report contained various adverse findings. He further argued that the report was qualified as he did not express an unqualified final opinion. He argued that the report was not required to be modified in a particular manner to express a qualified opinion.

5. He further argued that he could not have been penalized under sub-section (1) of section 260 unless the Commissioner found that the discrepancies in his report amounted to a default under the said section and the said default was willful in nature. He referred to the definition of the term 'willful' given in the Black's Law Dictionary and stated that unless it could be proved that the default was malafide and done with criminal intent, no penalty could be imposed on him. He insisted that even if he was found to be negligent, he could not be penalized under section 260, as negligence was different from willful default. He maintained that no loss had been caused to the Company or its shareholders and therefore he should not be penalized and the Impugned Order should be set aside.

6. Ms. Sumaira Siddiqui appearing on behalf of the Commissioner pleaded that the Appellant had committed violations of law by not disclosing material facts to the members of the Company as required by section 260 of the Ordinance and not preparing the audit report in conformity with the requirements of section 255. She contended that as a requirement of the Ordinance, the auditors were obligated to audit the accounts of listed companies according to the International Accounting Standards (IAS) as well as International Standards on Auditing (ISA). She referred to Para 102 (d) of IAS 1 and argued that the absence of employees in the Company does



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not warrant that the disclosure of the same should not be made in the accounts. The auditors should have disclosed the fact that there were no employees of the Company. She contended that all accounting policies should be disclosed and the staff liability, even if negligible, should have been disclosed separately by the auditors. She relied on Para 48-101 and Para 120 for disclosure given in IAS 19.

7. Ms. Siddiqui stated that the term 'material', although not defined in the Ordinance, has been defined in the ISA Committee's 'Framework for the Preparation and Presentation of Financial Statements'. She maintained that the policies of stock in trade and revenue recognition are important accounting policies and have to be disclosed regardless of their immateriality. She contended that the opinion on 'going concern' basis has to be expressed in unambiguous terms, which the Appellant failed to do. She further contended that the IAS gives a defined format in which the opinion of the auditor on the 'going concern' basis should be expressed.

8. We have heard the parties in detail and perused the documents on record. We have also examined the law on the subject. In our opinion the following two issues need to be decided in this appeal:

(a) whether the Appellant has committed a default punishable under section 260 of the Ordinance; and

(b) whether the default has been committed willfully.

9. On the grounds enumerated herein below, we have found the answer to both these questions in positive and therefore uphold the penalty imposed on the Appellant in the Impugned Order.

10. The Appellant has been penalized by the Commissioner for not preparing the audit report in conformity with the requirements of section 255 of the Ordinance, and for failing to bring out material facts about the affairs of the Company. The Appellant



has sought to argue that the contraventions alleged against him do not even amount to default. We cannot accept this contention. The auditors are required by law to prepare the accounts of the company according to the IAS as applicable in Pakistan. Para 102(d) of IAS 1 clearly lays down the requirement on the auditor to disclose the number of employees. In addition, IAS 19 requires the disclosure of employee benefits. In our view thus, there is no room for the Appellant to argue that he used his discretion in not reporting the number of employees or employee liabilities in the report. His argument that these are not material facts is also 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*'. There cannot be two arguments that such information that the company has no employees can and should influence the economic decisions of the users of the financial statements. Such information would convey the message to the users that the Company is in fact closed down as was claimed by the Appellant in his statement before the Bench.

11. Conversely, however the financial statements of the Company for the relevant year disclose a total amount of Rs.422,498/- under the head of salaries and wages. The statements further show annual sales of Rs.3,494,050/-. These figures cast a major doubt on the Appellant's statements before the Bench that the Company was closed down at the time and had no employees at all. These contradictions point to the fact that the Appellant has failed in his duty to report to the shareholders that the statements do not give the information required by the Ordinance and also do not give a true and fair view as is required under section 255 of the Ordinance.

12. With regards to issue of Appellant's failure to qualify his report, his argument that the report should be considered as qualified as it was not unqualified, is untenable. Where the auditor gives a qualified opinion, he is required to express clearly the nature of the qualification along with the reasons for such qualification and express his opinion subject to the reservations that he has. He should not leave it



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to the shareholders to determine the facts by making diligent inquiry. 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 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...'. Similarly, the Appellant has also failed to express an adverse opinion on the going concern assumption in clear and unequivocal terms. The ISA requires that if in the judgment of the auditor the entity will not be able to continue as a going concern, the auditor should express an adverse opinion if the financial statements have been prepared on a going concern basis. In the present case, whereas the Appellant has identified in his report various impediments in the Company continuing as a going concern, he has failed to give an adverse or qualified opinion and conclude that the accounts, which have been prepared on going concern basis, do not give a true and fair view. In the auditors report to the members, the Appellant has admitted that the audit has been conducted in accordance with the auditing standards as applicable in Pakistan. If that was the case then the Appellant would have expressed an adverse or qualified opinion in the format recommended in the IAS. We therefore agree with the Commissioner that the Appellant has committed a default by not disclosing material facts as required by section 260 of the Ordinance.

13. On the second issue, it is clear from the plain reading of sub-section (1) of section 260 of the Ordinance that the auditor can only be penalized if the default committed by him is willful. The Appellant has sought to argue that 'willful' means that the default was malafide and committed with criminal intent. The law, as laid down by the superior courts is that whereas intent is a necessary ingredient of willfulness, impropriety is not. **(1960) 30 Com Cases 523**. It is therefore not necessary to prove that the default committed by the Appellant was malafide.



14. As far as 'intent' is concerned, the courts have laid down different tests to infer the same from a person's acts and omissions. In the case cited at **NLR 1988 TD 11** it was held that there must be some evidence, direct or circumstantial, to sustain the inference that the person has contributed to the default with full consciousness of his responsibility in the matter. In **Burton v. Bevan (1908) 2 Ch 240**, it was held that the term 'knowingly' signifies knowledge of the facts on which the contravention depends and 'willfully' signifies that the person concerned realizes that there is a contravention.

15. As a professional accountant and the statutory auditor appointed by the shareholders, there was a fiduciary duty cast upon the Appellant. Characteristically, the fiduciary is required to have greater knowledge and expertise about the matters being handled and is held to a standard of conduct and trust above that of a stranger or of a casual business person. If the requirements of law on a particular matter are clear, it is totally wrong for the fiduciary to claim that he did not deem the requirements to be necessary. The Appellant has taken that plea when the above facts reveal that the applicable auditing standards require that the disclosures should have been made by him. More significantly, in the auditors report to the members, the Appellant has admitted in clear terms that the audit has been conducted in accordance with the auditing standards as applicable in Pakistan. On one hand it amounts to a misstatement and a breach of fiduciary duty. On the other hand, it points to the fact that the Appellant was fully conscious of his duty to follow the auditing standards. And his realization of the apparent default can thus be justifiably inferred from his knowledge and expertise as a professional accountant and auditor. 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



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in default. We therefore are of the opinion that the Appellant has committed a breach of his fiduciary duty with knowledge and intent.

16. In light of the above findings, the order of the Commissioner is upheld. The appeal is accordingly dismissed.

(DR. TARIQ HASSAN)
Chairman/Commissioner

(SHAHID GHAFAR)
Commissioner

Announced in Islamabad on June _____, 2004