Before

Shahzad Afzal Khan – Director/Head of Department
Adjudication Department-I

In the matter of

Fatima Fertilizer Company Limited

Show Cause Notice No. & Date:	No. CSD/ARN/215/2015-36 dated February 26, 2024
Date of hearing	June 12, 2023, July 27, 2023 and August 9, 2023
Hearing attended by:	Mr. Kashif Mustafa Khan, GM Finance, Authorized Representative

ORDER

Under Section 199 of the Companies Act, 2017

This Order shall dispose of the proceedings initiated through Show Cause Notice No. CSD/ARN/15/2015-167 dated February 26, 2024 (**the SCN**) issued under Section 199 of the Companies Act, 2017 (the **Act**) against Fatima Fertilizer Company Limited (the **Company**) and its Board of Directors, hereinafter collectively referred to as the **Respondents**.

2. The brief facts of the SCN are that the Securities and Exchange Commission of Pakistan (the **Commission**) reviewed the audited accounts for the year ended December 31, 2022 (the **Accounts**) of the Company. The Accounts revealed that the Company during the year, sold its investment property at a consideration of Rs. 529.945 million (Note 37 to the Accounts), to its wholly owned subsidiary, Fatima Cement Limited (**FCL**). However, the disposal proceeds were not yet received as of the close of the financial year and were aggregated under "Long Term Advances and Deposits" amounting to Rs. 2,114.948 million in the statement of financial position.

3. As the Company has classified the outstanding disposal proceeds as advance to its subsidiary FCL, *prima facie*, it was required to comply with the requirements of Section 199(2) of the Companies Act, 2017 (the Act).

4. The Commission vide email dated May 30, 2023 sought comments from the Company. In reply the Company vide its letter dated June 07, 2023 *inter alia* submitted that:

> *"..... As FCL is a wholly owned subsidiary, the Company is incurring all the expense on behalf of FCL being the sole shareholder. For the sake of argument, if we charge or book mark-up on such advances then ultimately the Company will be paying the amount of mark up to itself on behalf of FCL as it is not yet operational. Further, the Company will be booking mark-up income, however at the same time the Company is fully cognizant of the fact that the same cannot be recovered as FCL is not yet operational. In order to present a true and fair view in*

compliance with the requirement of IFRS, the Company has to remeasure the recoverability of the outstanding markup and book provisions accordingly. Therefore, as per our understanding the law should be applied rationally to present a true and fair view of the financial position of the Company and complying with the requirements of section 199(2) of the Act for a greenfield project does not serve any purpose. In addition, the Company is burdened with tax inference on mark-up income which is only a book entry.

Further, from the legal point of view there appears an anomaly in the provisions of section 199 of the Companies Act, 2017 with regards to investment in wholly owned subsidiary. On the one hand the law exempts the investment in wholly owned subsidiary from the requirements of sub-section(1), however, sub-section (2) is applicable to the wholly owned subsidiary which serves no purpose except for accounting entry.

5. From the aforementioned reply of the Company, it is evidently clear that, *prima facie*, the Company, while advancing to its wholly owned subsidiary, FCL, has failed to comply with the requirements of Section 199(2) of the Act, punishable under Section 199(6) thereof. The provisions of the law are explicit as the exemption under Section 199(1) is to the extent of a "special resolution" and not under the provisions of Section 199(2) of the Act.

6. In view of the above, proceedings under Section 199 of the Act were initiated against the Respondents through serving the SCN requiring them to show cause in writing within ten (10) days, as to why penalty, as provided, should not be imposed on them.

7. In response to the SCN, the Company vide letter dated March 12, 2024, submitted that:

"....
Fatima Cement Limited (FCL), is a wholly owned subsidiary of the Company and is set up to establish a Greenfield cement manufacturing plant at various locations. FCL was incorporated on July 26, 2016, as a public unlisted company. The objective of FCL is the production and sale of cement by erecting a cement plant with a production capacity of 9,000-10,000 MTPD of clinker. The project is in early stages of development whereby land and mining lease licenses have been acquired for the said purpose. The project is totally dependent on the Company, being the sole sponsor of this project. The Board of Directors in their meeting held on April 27, 2022, approved the project with a total estimated cost of USD 274 million. Further, approval of the shareholders was obtained on April 29, 2022.

The Company being sole sponsor of FCL, had been investing in the project through purchase of land for FCL, bearing expenses on behalf of FCL and extending advances for meeting day to day administrative and operational cost.

The Company in response to the SECP query raised an argument that if the Company charge or book mark-up on advances to wholly owned subsidiary then ultimately the Company will be paying the amount of mark up to itself on behalf of FCL as it is not yet operational. In order to present a true and fair view in compliance with the requirement of IFRS, the Company has to remeasure the recoverability of the outstanding markup and book provisions accordingly.

Therefore, as per our understanding the law should be applied rationally to present a true and fair view of the financial position of the Company and complying with the requirements of section 199(2) of the Act for a greenfield project does not serve any purpose. In addition, the Company is burdened with tax inference on mark-up income which is only a book entry. Further, from the legal point of view there appears an anomaly in the provisions of section 199 of the Companies Act, 2017 with regards to investment in wholly owned subsidiary. On the one hand the law exempts the investment in wholly owned subsidiary from the requirements of sub-section (1), however, sub-section (2) is applicable to the wholly owned subsidiary which serves no purpose except for accounting entry.

However, giving due recognition to the observation of SECP the management decided to charge and recover markup on the outstanding amount on annual basis.

It is further submitted that, FCL issued right shares in June 2023 and repaid all the outstanding advances to the Company aggregating to Rupees 1,045,965,872, including markup recoverable of Rupees 74,562,177.

As the Company has complied with the requirements of law in letter and spirit therefore, it is requested to close the show cause proceedings without any adverse order."

8. To provide opportunity of personal representation, hearing in the matter was fixed for March 13, 2024, wherein Mr. Kashif Mustafa Khan, GM Finance, appeared before the undersigned on behalf of the Respondents as their Authorized Representative (the **Representative**) reiterated the submissions made in the written reply dated March 12, 2024.

9. The Company in furtherance to the aforesaid hearing, vide its email dated March 13, 2024, also submitted the following:

1. *Bank statement of Fatima Cement Limited*
2. *Bank statement of Fatima Fertilizer Company Limited*
3. *Calculation of Mark up*
4. *Tax payment receipt*

10. Before proceeding further, it is necessary to refer to relevant legal provisions, which are reproduced as under:

Section-199 of the Act:

(2) The company shall not invest in its associated company or associated undertaking by way of loans or advances except in accordance with an agreement in writing and such agreement shall inter-alia include the terms and conditions specifying the nature, purpose, period of the loan, rate of return, fees or commission, repayment schedule for principal and return, penalty clause in case of default or late repayments and security, if any, for the loan in accordance with the approval of the members in the general meeting:

Provided that the return on such investment shall not be less than the borrowing cost of the investing company or the rate as may be specified by the Commission whichever is higher and

shall be recovered on regular basis in accordance with the terms of the agreement, failing which the directors shall be personally liable to make the payment:

Section 199(6) of the Act:
(6) Any contravention or default in complying with requirements of this section shall be an offence liable to a penalty of level 3 on the standard scale and in addition, shall jointly and severally reimburse to the company any loss sustained by the company in consequence of an investment which was made without complying with the requirements of this section.

11. At this juncture, following issues are required to be addressed:

a. Whether the provisions of Section 199(2) are applicable on a wholly owned subsidiary which is not operational and the parent company is incurring its expenses.

b. Whether it is imperative to charge and recover mark-up on advances to a wholly owned subsidiary (*non-operational*) to represent a true and fair view of the group's financial position.

12. I have reviewed the facts of the case, considered the written and verbal submissions made by the Respondents and the Representative in the light of the applicable legal provisions and available record before me and accordingly, address the following aforementioned issues:

a. **Whether the provisions of Section 199(2) are applicable on a wholly owned subsidiary which is not operational and the parent company is incurring its expenses.**

Yes. Section 199(2) of the Act provides that the company shall only invest in its associated company or associated undertaking by way of loans or advance in accordance with an agreement in writing and such agreement shall include the terms and conditions, specifying: (i) the nature, purpose and period of loan, (ii) rate of return on loan; (iii) fees or commission; (iv) repayment schedule for principal amount and return; (v) penalty clause in case of default or late repayments; and (vi) security, if any, for the loan in accordance with the approval of the members in the general meeting. Furthermore, the return on such investment shall not be less than the borrowing cost of the investing company or the rate as may be specified by the Commission whichever is higher and shall be recovered on regular basis in accordance with the terms of the agreement, failing which the Company/directors shall be personally liable to make the payment.

In view of the aforementioned, there is no exemption or exception to the requirements of the Section 199(2) of the Act applicable on the transaction conducted between the Company and its wholly owned subsidiary.

b. **Whether it is imperative to charge and recover mark-up on advances to a wholly owned subsidiary (*non-operational*) to represent a true and fair view of the group's financial position.**

Yes. To present a true and fair view of the financials of a group comprising of a holding and its subsidiary, chargeability and recovery of the mark-up on advances in compliance to the provisions of Section 199 of the Act and the IFRS is imperative. The parent's and its subsidiary's stand-alone accounts must incorporate the financial transactions to present a true and fair view. The ultimate consolidation of the accounts does cater the intra-group transactions, therefore, the Company's stance of avoiding a book entry for chargeability / recovery thereof, is not tenable under the principals of the IFRS and the Act. Furthermore, the Company's stance on tax inference on mark-up income as only a book entry is also without substance as tax chargeability / payment of the same is applicable under the relevant laws of taxation.

13. Keeping in view the above, as evident from the documentary information provided, the Company's management had decided to charge and recover the mark-up on the outstanding amount. The documentary information shared by the Company vide its email dated March 13, 2024, corroborates the mark-up charged and recovered from FCL. Additionally, the withholding tax on the same was also paid on June 27, 2023. However, the contravention of the provisions of Section 199 (2) of the Act, at the relevant point of time, has been established and same has been admitted by the Representative as well. The Respondents are, therefore, liable for penalty under Section 199(6) of the Act. In view of foregoing, I hereby impose penalty of **Rs. 100,000/- (Rupees Hundred Thousand Only)** on the Company and **Warn** the remaining Respondents.

14. The Company is, hereby, directed to deposit the aforesaid amount of penalty in the designated bank account maintained in the name of the *Securities and Exchange Commission of Pakistan* with MCB Bank Limited or United Bank Limited within thirty (30) days from the date of this Order and to furnish a receipted bank challan to the Commission forthwith. In case of failure to deposit the penalty, the proceedings under Section 485 of the Act will be initiated for recovery of the fines as arrears of land revenue.

15. Nothing in this Order may be deemed to prejudice the operation of any provisions of the Act providing for imposition of penalties on the Respondent in respect of any default, omission or violation thereof.

Shahzad Afzal Khan
Head of Department
Adjudication Department-I

Announced:
Dated: March 28, 2024
Islamabad