

Before Tahir Mehmood, Executive Director (Enforcement)

In the matter of

Adam Sugar Mills Limited

Number & Date of the Show Cause Notice: EMD/233/330/2002-2899 dated August 19, 2009

Date of Hearing: September 29, 2009

Present:

ORDER

Under Section 492 read with Section 476 of the Companies Ordinance, 1984

This order shall dispose of the proceedings initiated against the directors including the Chief Executive (the “respondents”) of Adam Sugar Mills Limited (the “Company”) through show cause notice dated August 19, 2009 issued under the provisions of Section 492 read with Section 476 of the Companies Ordinance 1984 (the “Ordinance”).

2. The Company is a public limited company incorporated in Pakistan under the Ordinance and its shares are listed on Karachi and Lahore Stock Exchanges. The authorized share capital of the Company is Rs.100,000,000/- dividend into 10,000,000 ordinary shares of Rs.10/- each and paid up capital of the Company is Rs.57,636,540/- divided into 5,763,654 ordinary shares of Rs.10/- each, as per latest available annual audited accounts of the Company for the year ended on September 30, 2008.

3. Brief facts of the case are that annual audited financial statements, (the “Accounts”) of the Company for the year ended September 30, 2008 which were submitted to the Commission vide Company’s letter dated January 20, 2009 revealed that auditors namely Haroon Zakria & Company, Chartered Accountants, (“the Auditors”) had qualified their auditor’s report to the members by, *inter alia*, making the following statement:

“During the current year, sales made to one of the customers are recognized on the basis of contractual arrangement instead of accounting policy as stated in note 3.14 to the financial statements. Had the revenue been recognized as per accounting policy, profit after tax would have been reduced by Rs.34.188 million.”

Note 3.14 to the Accounts disclosed Company’s accounting policy for recognition of revenue from sales as under:

“Revenue from sales of sugar is recognized on dispatch of sugar to customers.”

The directors in their report annexed to the Accounts replied to the above qualification of the auditor as under:

“The Company has recognized the revenue in respect of contract sales as these were confirmed and subsequent to the year-end and before the finalization of financial statements, the Company has received all the amounts against this sale.”



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4. The Commission vide letter dated May 21, 2009 required the Company to provide explanation with regard to the recognizing the sale not pertaining to the financial year, in violation of the Company's policy. The Chief Executive of the Company vide letter dated June 20, 2009 replied that the Company had recognized contractual sales because contracts were made, substantial amount of advances were received before the close of financial year and goods were dispatched and amounts realized subsequent to the financial year end but before the issuance of financial statements. The information provided by the Company also revealed that as a result of recognition of sales in contravention of the Company's policy stated under note 3.14 to the Accounts, the Profit and Loss Account of the Company for the year under review had been misstated as net after tax profit had been overstated by an amount of Rs.34.188 million, Sales overstated by Rs.233.338 million and Cost of Sales overstated by Rs.148.967 million.

5. Consequently a show cause notice was served on the directors of the Company under the provisions of Section 492 of the Ordinance, which, inter alia, prescribes penalties for misstatement in the Accounts. The Company vide letter dated September 16, 2009 made submissions in response to the show cause notice, as under:

- i.) Section 492 of the Companies Ordinance, 1984 deals with false or incorrect statement and omission of material facts while in our particular case recognition of contractual sales of Rs.233.338 million resulting in profit of Rs.34.188 million is a matter of record being dealt under International Account Standard IAS-18 "Revenue". Our company had issued delivery orders for aforesaid sale which is source document for validating dispatch of goods and accordingly recognized revenue of such sale on the ground that risks and rewards for such sale are transferred and also the buyer has right of resale of such delivery orders. Resale of delivery orders is a commercial practice which confirmed that buyers have risk and rewards of goods.
- ii.) Substantial amount of this sale was received before the end of the financial year. The auditors of the Company have made such observations in their report due to pending physical delivery of goods, however, we believe that on dispatch of delivery orders, risks and rewards are accordingly transferred and compliance of IAS-18 "Revenue" has also taken place. This treatment could be regarded as an error rather than as misstatement, hence, on such error provisions of Section 492 read with Section 476 of the Ordinance, should not be invoked, as the Auditors have qualified that error in their Audit Report accordingly.
- iii.) Definition of prior years' as given in IAS-8 is reproduced hereunder:

"Prior period errors are omissions from *the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- (a) was available when financial statements for those periods were authorised for issue; and
- (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud."

*(*The words "and misstatement in" had been intentionally omitted by the Company from the definition quoted to support the respondents' point of view)*



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- iv.) IAS-8 also prescribes accounting treatment for correction of such errors, failing to comply with such treatment; our previous treatment could be regarded as error on human part.
- v.) Considering these facts we are of the view that on qualification by the Auditors, we have recognized that prior year's error and are bound to comply with the requirements of IAS-8 which in turn will fulfill our compliance with IAS-18.
- vi.) It is well settled law that errors, if caused in prior period are subsequently made good with its ratification as required under the law, then the same stands ratified and any coercive or the punitive action on such ratification would be against the spirit of basic principle of natural justice. Hence, the instant proceedings initiated under Section 492 read with Section 476 of the Ordinance, deserve to be withdrawn in the interest of natural justice.
- vii.) SECP is therefore, requested to kindly drop the instant proceedings keeping in view the position explained above and that all the seven directors including the company may please be exonerated if such error which was subsequently ratified is even considered to be adjudicated.

6. The Company's reply to the show cause notice was not found satisfactory, therefore, in order to provide an opportunity of hearing, the case was held October 9, 2009, in Karachi. On the date of hearing, Mr. K.D. Rajani, Advocate (the "Counsel"), appeared before the undersigned on behalf of all the respondents. He reiterated the earlier stance of the respondent as per written submissions and also presented copies of delivery orders issued by the Company to support the plea that recognition of sales on contractual basis was justified because delivery orders were issued prior to the close of financial year. The counsel also requested to fix a second hearing in the matter for submission of additional information and documents relating to the case. The second hearing was fixed in Islamabad on October 12, 2009. The respondents or their representative did not appear on the due date, therefore, another opportunity was provided and hearing was fixed on October 19, 2009. Mr. Ghulam Ahmad Adam, the Chief Executive of the Company, appeared before the undersigned on the date and mainly reiterated the earlier stance. He was apprised of the fact that the management of the Company could have easily reversed the entries pertaining to those sales wrongly accounted for in the Accounts, after the auditors had given their observations/qualification. As they failed to do so, therefore, the default appears to be intentional. As a result, Mr. Adam admitted the default and requested to condone the same.

7. I have analyzed the facts of the case, provisions of Sections 492 of the Ordinance, arguments put forth by the respondents and their counsel in writing and during the hearing and observed as under:

- The profit and loss account forming part of the Account has been materially misstated as the Company recognized contractual sales of Rs.233.338 million in clear violation of the Company's policy of recognizing revenue from sale of sugar on dispatch of the same to the customer. This is also in contradiction with the industry practice whereby sales are recognized by sugar companies on dispatch of sugar to the customers. As a result of this violation of Company's policy, Sales are inflated by 33.87%, Cost of Sales overstated by 23.45% and Net after tax profit overstated by eight times i.e. 790.5%. It is also worth mentioning that the directors of the Company have not reported figures of inflated sales, cost of sales and net profit in their report annexed to the Accounts. Besides that Note 3.14 to the Accounts states that revenue from sale of sugar is recognized on dispatch of sugar to



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customers without providing there an explanation that this policy has not been complied with in respect of the afore-referred contractual sales. Only the auditors have qualified the report, which only mentions overstatement of net after tax profit, while no figures of overstated sales and cost of sales have been report anywhere in the annual report. Besides that, it is also my considered view that auditors' qualification referring to the overstatement of net after tax profit does not render good the default committed by the Company and its directors, by including in the Accounts the contractual sales which did not pertain to the financial year ending on September 30, 2008 but were rather sales pertaining to the following year ending on September 30, 2009.

- Recognition of sales on receipt of advance is against the stated policy of the Company for revenue recognition and is also against the industry practice. Besides that mere issuance of delivery orders on receipt of advances does not transfer the risks and rewards as the inventories are not specifically identifiable against these delivery orders and risks remains with the Company till the inventories are dispatched to or lifted by the customers. Therefore, the afore-referred contractual sales without dispatch to the customers do not fulfill the criteria set forth by IAS-18. In this context, the Company's plea that contractual sales were recognized because substantial advances were received against these sales prior to the close of financial year is irrelevant. Besides that it also does not seem to be correct, as the copies of some of the delivery orders produced by the Company clearly show that advances of Rs.1 per Kg. and Rs.2 per Kg. only had been received in some cases, while there is not mention of advance amount in case of most of the delivery orders. These nominal amounts do not qualify as substantial amounts.
- The Company in its response has quoted definition of errors and omissions in the financial statements as defined in IAS-8, but advertently has omitted the word "misstatement". Errors and omissions from and misstatements in the financial statements of an entity have been defined concurrently in the said IAS-8. Company's treatment of including next years' sale in the Accounts for the year ended on September 30, 2008 resulting in inflated sales, cost of sales and net profit is clearly a misstatement and it is also material misstatement, as per criteria set forth by IAS-8, which states that:

"Material Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor"
- Company's stance that this is an error pertaining to previous year and is being ratified subsequently, is not relevant, because the instant proceedings relate to misstatement in the Accounts FYE September 30, 2008 and such misstatement was identified during the examination of these Accounts and proceedings have also been initiated based on this default. Company's plea that the default is being made good in the next year's account and penalizing the directors and the Company for the default subsequently ratified is against natural justice, is also not tenable. Instance of default once committed held the defaulters liable for punitive action under the law, and default subsequently made good does not discharge the defaulters of their liabilities arising out of such default, under the provisions of law.
- Besides, that if Company's plea, which is not justified, is accepted, it would set wrong precedent and some of the companies might take undue advantage by treating advances from customers as sales without dispatch of good during a particular year resulting in inflated sales and profit and ratifying the same during next year.



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8. Before proceeding further, it is necessary to advert to the following relevant provisions of Section 492 of the Ordinance, which states as under:

“ Whoever in any return, report, certificate, balance sheet, profit and loss account, income and expenditure account, prospectus, offer of shares, books of accounts, application, information or explanation required by or for the purposes of any of the provisions of this Ordinance or pursuant to an order or direction given under this Ordinance makes a statement which is false or incorrect in any material particular, or omits any material fact knowing it to be material, shall be punishable with a fine not exceeding five hundred thousand rupees.”

9. The aforesaid provisions of the law are clear and explicit. Considering the facts and circumstances of the case and analysis of relevant record, it is evident that directors have contravened the provisions of Section 492 of the Ordinance. It is my considered view that the respondents in their capacity as directors of the Company are responsible for the misstatement in the profit and loss account forming part of the Accounts and this misstatement certainly falls within the ambit of the provision of Section 492, as incorrect figures have been reported in the Account, as stated in the preceding paragraphs. I have also observed that once the Auditors had given its qualification with regard to wrong recognition of contractual sales without dispatch of goods, the respondents could have authorized exclusion of such sales from the Accounts before final version of the Accounts was published, and hence could have avoided the misstatement in the Accounts. The directors' failure to do so is a clear indication that the default was intentional and deliberate. One of the main objectives and intent of Section 492 of the Ordinance is to protect the users, which may include investors, shareholders, creditors, bankers, customers etc., of financial statements against misstatements so that reliable financial information which is vital for making a well informed decision is available to them. Due to this fact, any leniency while deciding the cases involving such instances of misstatements in the Accounts would defeat the whole purpose of the legislation. Circumstances of the case warrant no sympathy for the respondents who have allowed and authorized misstatement in the Account of the Company.

10. For the foregoing reasons, I am of the firm opinion that the provisions of Section 492 of the Ordinance have been violated and the respondents are liable for the penalties as prescribed by this Section. Therefore, in exercise of the powers conferred by the aforesaid provisions of the Ordinance, I hereby impose a fine of Rs.3,500,000/- (Rupees three million five hundred thousand only) in aggregate on all the respondents for contravening the provisions of Section 492 of the Ordinance. The respondents are directed to deposit the aggregate fine of Rs.3,500,000/- (Rupees three million five hundred thousand only) in the following manner:

Name of Respondents	Amount in Rupees
1. Mr. Ghulam Ahmad Adam, Chief Executive	Rs.500,000
2. Syed Rafique Mohammad Shah, Director	Rs.500,000
3. Mr. Abdullah Karim, Director	Rs.500,000
4. Mr. Jawaid Ahmed, Director	Rs.500,000
5. Lt. Col. (Rtd.) Muhammad Mujtaba, Director	Rs.500,000
6. Mr. Junaid G. Adam, Director	Rs.500,000
7. Mr. Omar G. Adam, Director	Rs.500,000
	Rs.3,500,000
(Rupees three million five hundred thousand only)	



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The aforesaid fines must be deposited in the designated bank account number 0183089871000097 maintained with MCB Bank Limited in the name of the "Securities and Exchange Commission of Pakistan" within thirty days from the receipt of this order and furnish receipted bank vouchers to the Commission. In case of non-deposit of the penalties, proceedings for recovery of the fines as arrears of land revenue will be initiated. It may also be noted that the said penalties are imposed on the respondents in their personal capacity; therefore, they are required to pay the said amount from personal resources.

11. Before departing with the order, I hereby invoke provisions of Section 473 of the Ordinance and direct the respondents, as under:

- To rectify the misstatement and ratify the default by restating in the financial statements for the year ended on September 30, 2009, the comparative figures of Sales, Cost of Sales, Gross Profit, Net Profit, Stocks in Trade and all the other relevant heads of accounts pertaining to the year ended on September 30, 2008; and
- In relation to all the comparative figures restated in the upcoming Accounts for the year ended on September 30, 2009, the fullest explanation and reason of such restatement must be provided prominently as foot note.

Tahir Mehmood
Executive Director (Enforcement)

Announced:
October 20, 2009
Islamabad