Before Rashid I. Malik, Commissioner (CL)

In the matter of

M/S Shahpur Textile Mills Limited

Under (Rule (5) Of The Companies (Issue of Capital) Rules, 1996 read with Section 492 and Section 472 Of The Companies Ordinance, 1984)

Number and date of notice	No. EMD/CO.233/194/2002 dated July 11, 2005
Date of hearing	November 15, 2005
Present	Mr. Imtiaz Majeed, Consultant Mr. Nasir Ali Khan , CFO
Date	January 18, 2006

ORDER

This order shall dispose of the proceedings initiated through Show Cause Notice No. EMD/CO.233/194/2002 dated July 11, 2005 against Shahpur Textile Mills Limited (the “Company”) under the provisions of rule 5 of the Companies (Issue of Capital) Rules, 1996 (the “Rules”) read with Section 492 and Section 472 of the Companies Ordinance, 1984 (the “Ordinance”).

2. The Company was incorporated as a public company limited by shares in the year 1987. The shares of the Company are listed on the Karachi and Lahore Stock Exchanges. The paid up capital of the Company is Rs.139.804 million divided into 13.9804 million ordinary shares of Rs.10 each. The Company is principally engaged in the manufacture and sale of yarn and allied products. Its manufacturing facilities are located at Chunian, District Kasur. The Company has 2,710 shareholders comprising individuals, investment companies, joint stock companies etc. and as per its pattern of shareholding annexed to the Directors’ Report in the accounts for the year ended June 30, 2005, directors, their spouses and minor children hold 73.77% of the total shareholding. This indicates that there is considerable public interest in the Company. Board of Directors of the company as per its annual report for the year ended June 30, 2005 comprises the following persons:

1.	Mr. Nazir Ahmed Peracha, Chief Executive
2.	Mrs. Qamar Nazir Peracha, Director
3.	Mrs.Feriha Nazir Peracha, Director
4.	Mrs. Uzma Asif Amin, Director
5.	Mrs. Cyma Fazal Peracha, Director
6.	Mr. Taymur Alam Peracha, Director
7.	Mr. Hasan Mahmood, (NIT) Director

3. Brief facts of the case are that during examination of annual accounts of the Company for the year-ended September 30, 2004 it was observed that share capital of the Company was increased from Rs.99.804 million in 2003 to Rs.139.804 million in 2004 as a result of 40.08 % right issue at par on December 30, 2003 under the companies (issue of capital) rules, 1996. Further, it was disclosed in the directors' report that trading in the shares of the Company by the CEO, Director and their spouses, during the year under review was as follows:

Name	**Sale**	**Purchase**
Mr. Nazir Ahmed Peracha-CEO	None	3,175,596
Mrs. Qamar Nazir Peracha-Director	None	173,386
Mrs. Feriha Nazir Peracha-Director	None	433,465
Mrs. Cyma Fazal Peracha-Director	None	217,153

It was also disclosed that the purchasing of right shares by CEO was on account of underwriting of right shares, he being underwriter to the right issue. The appointment of CEO as underwriter was in violation of the Balloters, Transfer Agents and Underwriters Rules, 2001 which attracted penal provisions contained in Section 22 of the Securities and Exchange Ordinance, 1969.

4. It was noticed that the circular sent to the members along with the notice offering new shares pursuant to the requirements of Section 86 (3) dated January 06, 2004 stated that the main projects/objects for which the additional funds were required were as follows:

> *"The management of the Company has decided to upgrade the production facilities of the unit by carrying on Balancing, modernization and Replacement of the existing plant, to meet the challenges of quota free era commencing in 2005."*

Further, as regards the expected benefits in profitability or otherwise likely to accrue from the proposed issue, following was stated:

> *"The increased production would result in reduced unit cost and the economies of scale. The improved quality of yarn would ensure customer satisfaction and better prices in future from the local and international market. Hence increasing the overall profitability of the company and paving good returns to the shareholders."*

5. Later on from perusal of financial projections prepared pursuant to Rule 5 of the Rules it was noticed that the project implementation was not completely in accordance with the financial projections. It was observed that the proceeds of the right issue were not utilized for the purposes disclosed in the financial projections submitted to the shareholders at the time of approval of right issue; instead these appeared to have been utilized for repayment of directors' loan. The resulting shortfall in finance was covered by obtaining short term financing from banks, which was not envisaged in the original projections. The post right issue scenario presented before the shareholders through the aforementioned circular was not visible, rather the latest financial results depicted the adverse financial position of the Company, as the loss for the period without the effect of extra ordinary gain from waiver of directors loan of Rs.11 million amounted to Rs. 17.340 million compared to the projected loss of Rs.5.509 million.

6. The above observations raised concerns about the state of affairs of the Company, a Show Cause Notice (the "Notice") was then issued to the Chief Executive and directors of the Company on July 11, 2005 asking them to explain the violation of Balloters, Transfer Agents and Underwriters Rules, 2001 and why penalty under Section 492 of the Ordinance may not be imposed on the Chief Executive Officer and the directors for aforesaid violation and why they may not be called upon in terms of the provisions of Section 472 of the Ordinance to make good the default within 30 days of the date of the notice by making payment of the entire amount of Rs.40,786,603 to the Company which was repaid to the directors out of the proceeds of right issue, including additional financial charges borne by the company due to the utilization of short term finance in place of the proceeds from right issue.

7. The company replied to the notice vide its letter dated August 09, 2005. Wherein, following submissions were made:

i. The Company has been making consistent losses for many years and its equity was negative.
ii. The average share price on Karachi Stock Exchange was at Rs.2.50 per share.
iii. The existing production facilities needed BMR to improve the quality.
iv. The production capacity needed to be upgraded to reduce the cost per unit.

- In order to achieve the above the management decided to carry out BMR and add spindles etc. to make the project viable. To implement this, project expansion plan was prepared in the year 2003 with an estimated cost of Rs.87 million, which was to be financed partly by the issue of shares up to Rs.40 million.

- After detailed discussion, the financial plan was approved by the board of directors of Shahpur Textile Mills Limited. A director representing NIT in the Company dissented from the resolution, however the resolution was approved by the Board. Being a listed Company, the Company had to go through KSE and SECP requirements/formalities relating to approval and implementation of right issue. In order to put the plan in place in the year 2003; the directors decided to contribute and provide funds as directors loan/ share deposit money to open Letter of credit for machinery and construct building.

- The funds contributed by the directors were utilized for civil work, construction of factory building and purchase of machinery. At the end of year 2003 this amount stood at Rs.53.50 million. This has been disclosed in the financial projections on page-7 under “share deposit money” and as last item in the projected balance sheet on page 15.

- The offer for right shares was at par Rs.10 each which was higher than its market value of Rs.2.50 per share. The financial institutions were approached but they were not prepared to act as underwriters for the issue due to large operational losses and issue price being higher than market price. To meet the requirement of Rule 5 of the Rules, the Board of Directors decided to appoint sponsor/director as underwriter for the issue. This was however a favour to the Company by the sponsor/directors to improve the financial health of the Company. The Company was however unaware of the requirements of the Underwriter Rules, 2001 and this led to the underwriting of shares in violation of the Balloters, Transfer agents and Underwriter Rules, 2001

- There was no money paid to the directors out of the proceeds of the Right Issue. This transaction is in accordance with the company financial projection plan for the Right Issue as in the projected balance sheet it was envisaged and planned that the directors loan/share deposit money given in the year 2003 for the purpose of expansion plan shall be repaid, it has been shown in the year 2004 projected accounts as reduction of Rs.31 million (year 1 page 15,) wherein the directors loan/share deposit money has been reduced from Rs.53.96 million to Rs.22.96 million. The transaction of Rs.31 million is dated March 16, 2003, which is prior to subscription date for right Shares Money deposited by the underwriters.

- As a result of right share subscription the equity has increased from Rs.99.80 million to Rs.139.80 million, the net impact being improvement in shareholders equity from negative of Rs.2.14 million to positive of Rs.45.51 million.

- As per financial projections the fixed capital expenditure was planned at Rs.87 million, the actual amount spent in 2003 was Rs.40.18 million and in year 2004 the amount was Rs.52.86 million, having a total of Rs.93.04 million.

- This is true that in the projections it was stated that the equity financing would save the interest cost and result in higher profitability for shareholders. The actual loss as per accounts for year 2004 is Rs.5.05 million compared to Rs.9.92 million as shown in the financial projections page 16, the actual results are better than projected loss.

- The short term borrowing for working capital requirement as shown in the financial projection on page 18 was estimated at Rs.45 million whereas in the accounts it is approx. Rs.70.79 million. This is because of the changes in the working capital requirements which increased to Rs.95.61 million due to 28% increase in turnover. The short term borrowing was entirely for the purpose of business due to increase in activity, higher cotton prices and raw material requirements.

- The directors had assets of Rs.51 millions in shape of receivables in the company, which have changed into an investment having value of Rs.10 million. Now they have no money for further investment in the Company and they are not in position to repay any amount as they did not take any funds from the Company.

8. The submissions of the Company were neither substantiated from actual results nor from the financial projections, and on the basis of an examination, limited to the extent of information disclosed in the historical financial statements of the Company, following facts were revealed:

- Major portion of the loan i.e. Rs.24.33 million originated as a result of invoking of guarantee by a creditor bank, due to which the loan from bank was transferred to the directors' name. Thus it was never an inflow for the purposes of BMR in the first place. Moreover, the Directors' loan was also observed to be outstanding since long and as claimed by the company the loan was not provided in 2003, the outstanding balance of the loan account at various points of time was as under:

Directors' Loan

Year	Loan outstanding	Increase	Markup
2000	35,805,898		14-15.5%
2001	39,892,151	4,085,253	14-15.5%
2002	53,956,944	14,064,793	14%
2003	56,500,170	2,543,226	14%
2004	4,761,567	(51,738,703)	Nil

- The fixed capital expenditure and funding sources utilized for the purpose was as follows:

Fixed Capital Expenditure and Funding Sources

	Additions in Fixed Assets Financed through			
Year	**Addition in Fixed Assets**	**Directors loan**	**funds generated from operations**	**Bank Borrowings**
1999	147,795		147,795	
2000	4,253,552		4,253,552	
2001	13,174,780		13,174,780	
2002	12,682,087	12,682,087		
2003	40,181,076	2,543,226		37,637,850
2004	52,856,058	-	-	52,856,058
	123,295,348	**15,225,313**	**17,576,127**	**90,493,908**

Repayment of the Directors loan out of the proceeds of the Right Issue

Directors loan repaid	**40,738,603**
Fixed Capital expenditure financed through Directors Loan (As explained above)	**15,225,313**
Repayment made in excess of the Fixed Capital expenditure financed through Director's Loan	**25,513,290**
Note: Proceeds from Right issue 40,000,000	

It was noticed that over the years total additions to fixed assets amounting to Rs.123.295 million were made, which were financed by a mix of directors' loan, funds generated from operations and bank borrowings. The maximum amount injected by directors for the purpose i.e. BMR was only Rs.15.225 million whereas a repayment on this account was made to the tune of Rs.40.738 million. These funds were wrongly claimed to be advanced to the Company for the purposes of BMR. Thus through misstatement of facts the directors managed to convert their long stuck loans into equity and caused dilution of ordinary shareholders' equity.

- The time of repayment of Rs.31 million i.e. before or after the right issue is immaterial. The fact that it was not utilized for the purpose for which funds were raised gave rise to concerns. A perusal of financial projections revealed an increase of Rs.40 million in the paid-up capital through right issue. Whereas, in the actual cash flow for the year 2004 Rs.40.738 million had been repaid to the directors and an inflow of Rs. 40 million was shown as proceeds from right issue. The Company representation that the financial projection provided that the Directors Loan extended in 2003 for BMR would be repaid is not supported by the facts because the maximum fixed capital expenditure in 2002 and 2003 that could have been financed out of Director loan amounted to Rs.15.225 million only, whereas Rs.40.738 million was repaid against the Directors loan. In the nutshell the substance of transaction is different from what is represented by the Company as the proceeds of the right issue were taken out on the pretext that funds were extended for the proposed BMR whereas as explained earlier these was not the actual facts.

- The circular sent to the members along with the notice offering new shares pursuant to the requirements of Section 86 (3) did not mention anything about the planned conversion/repayment of loan against the right issue. Thus the facts appeared to have been misrepresented before the shareholders.

- The effective actual loss before tax is Rs.17.340 million and this has been netted off with the waiver of Rs.11 million. The projected loss before tax for the year was Rs.5.508 million.

- The Company's arguments regarding increase in working capital requirement were also not supported by the facts. The change in requirements when incorporated in the working capital estimations model revealed that no further borrowings beyond the level already determined in the earlier projections was required.

- The conversion of director's loan at Rs.2.5 per share against right offer at Rs.10 per share because market price was Rs.2.50 per share cannot be considered an argument to justify the violations because the substance of the transaction was never disclosed as such.

- Further the explanations regarding benefit to the Company by incurring of capital expenditure and effect of transaction on the negative equity cannot be considered as a justification for the aforesaid violation and moreover benefits if any, cannot be related to right issue because practically no funds have been injected into the company through right issue.

- The projections were submitted by the Company in September 2003, and data for the year 2002 was used as base year. It is viewed that the projections should have been based on the latest data available at that time. This shows that the projections were not prepared with due care.

9. In order to give an opportunity to the management of the Company to clarify their position, a hearing was fixed on October 20, 2005, which was adjourned at the request of the Company and was re-fixed on November 15, 2005.

10. On the date of hearing Mr. Imtiaz Majeed, Consultant and Mr. Nasir Ali Khan, Chief Financial officer appeared on behalf of the Chief Executive and directors of the Company.

11. During the hearing, submissions made in the written reply were reiterated and it was accepted that the Company was unaware of the Balloters, Transfer agents and Underwriter Rules, 2001. They were informed that since these Rules have been made under the Securities and Exchange Ordinance, 1969 therefore this violation results in violation of the Ordinance for which penalty has been provided in Section 22(1)(b) of the Ordinance up to Rs.100,000. A request for condoning of this default was made. It was stated that the directors gave loans to the Company in the form of share deposit money with the intention of its utilization in the BMR and the fact was disclosed by them in the accounts under the note pertaining to loan from directors; however the loan was not classified as such. It was contested that the directors did not take away the amount, from the right share money as the transaction did not involve any cash. It was emphasized that the directors were trying their best to improve the condition of the Company which is evident from the fact that they have changed assets of Rs.51 millions in shape of receivables in the

company into an investment having value of Rs.10 million only. Infact the directors have lost Rs.7.50 per share resulting in net loss of Rs.30 million.

12. As regards the lack of any visible improvement in the financial results of the Company when compared to the financial projections and benefits of right issue not being tangible, it was stated that the management foresees better results in the near future. It was also committed that detailed financial affairs with reference to the project will be submitted to the Commission.

13. I have considered the facts of the case and observed that the Chief Executive, while agreeing to act in the capacity of an underwriter, is expected to have full knowledge of all relevant statutes. Therefore, I reprimand the Chief Executive to remain careful in future while complying with the statute. Further, the circular communicating right offer to the shareholders filed with the Registrar and shareholders pursuant to Section 86 (3) of the Ordinance did not disclose the actual intentions of the Directors that the right issue proceeds would be utilized towards conversion of directors' loan into equity. Moreover the fact that the amount repaid to the directors is in excess of funds injected for the purposes of BMR raises concerns about the managements' representations made before the shareholders and the Commission from time to time. The fundamental information regarding capital expenditure, working capital requirements, directors' loan, and operating results provided in the projections for the offer of the right issue was thus incorrect and material facts were omitted.

14. In view of the above, I instead of imposing maximum penalty of Rs.100,000 on the Chief Executive and each director as prescribed by Section 492 of the Ordinance, impose a fine of Rs.50,000 on each of the following Directors and Chief Executive:

1.	Mr. Nazir Ahmed Peracha, Chief Executive
2.	Mrs. Qamar Nazir Peracha, Director
3.	Mrs.Feriha Nazir Peracha, Director
4.	Mrs. Uzma Asif Amin, Director
5.	Mrs. Cyma Fazal Peracha, Director
6.	Mr. Taymur Alam Peracha, Director

The afore-named persons are directed to deposit the aforesaid fine in the designated bank account maintained in the name of Securities & Exchange Commission of Pakistan in the Habib Bank Limited within 30 days of the date of this order and furnish a receipted challan to the Commission in this regard.

15. Since, the concerns of the Commission regarding the Company's profitability remained unresolved, the Chief Executive Officer and Directors are directed under provisions of Section 472 of the Ordinance to provide the financial plan after carrying out due diligence within 60 days of the date of this order, with particular reference to the following:

1. Working capital requirement planned and the current requirement
2. Business Strategy to bring the Company out of current situation of operational losses.

16. The Chief Executive and Directors of the Company are hereby directed to deposit the aforesaid fine totaling to Rs.300,000 (Rupees Three hundred thousands only) in the designated bank account maintained in the name of Securities and Exchange Commission of Pakistan with Habib Bank Limited within thirty days from the receipt of this Order and furnish receipted vouchers or pay by a DD/pay order issued in the name of Commission for information and record, failing which proceedings under the Land Revenue Act,1967 will be initiated which may result in the attachment and sale of movable and immovable property. It may also be noted that the said penalties are imposed on the Chief Executive and other Directors in their personal capacity who are required to pay the said amount from their personal resources.

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Rashid.I.Malik
Commissioner (CLD)