Corporate Supervision Department
Company Law Division

SECP

Before Abid Hussain – Executive Director (CSD)

In the matter of

Service Fabrics Limited

Number and date of SCN:	CSD/ARN/199/2015-495-501, dated August 11, 2016 read with addendum CSD/ARN/199/2015-587 dated August 19, 2016
Hearing held on:	October 6, 2016
Present:	Mr. Ahmed Bashir, Mr. Musa Janjua and Mr. Zafar Iqbal

ORDER

UNDER SECTION 492 READ WITH SECTION 476 OF THE COMPANIES ORDINANCE, 1984

This order shall dispose of the proceedings initiated against the following directors including the chief executive officer (together referred to as "respondents") of **Service Fabrics Limited** (the "Company"):

1	Mr. Aurangzeb Noor, Chief Executive	5	Mr. Irfan Noor, Director
2	Mrs. Mudassara Aurangzeb, Director	6	Mrs. Sara Anjum, Director
3	Mrs. Azmat Akbar, Director	7	Mr. Ali Anwar, Director
4	Mr. Muhammad Waqas, Director	8	Mr. Omer Salah Ahmed, Ex-Director

The proceedings against the respondents were initiated through show cause notice dated August 11, 2016 under the provisions of section 492 read with section 476 of the Companies Ordinance, 1984 (the "Ordinance") and subsequent addendum dated August 19, 2016 (together referred to as the "SCN").

2. The brief facts of the case are that pursuant to an inspection order dated May 5, 2016 under section 231 of the Ordinance, an inspection of the Company was conducted by the Commission. During the course of inspection, it was revealed that the financial statements of the Company for the half year ended December 31, 2015 ("Half Yearly Accounts") were, prima facie, misstated, as under:

i. An amount of Rs.15.243 million was booked through a journal entry by crediting the directors' loan and debiting the 'Investment in HK Securities Private Limited' ("HKSPL") in the Half Yearly Accounts. Despite the fact that no cash was received or paid by the Company in respect of the above transaction till December 31, 2015, it was reflected in the cash flow statement as outflow 'investment in subsidiary' under investing activities and as inflow 'long term financing' under the financing activities, resulting in, prima facie, misstatement in the cash flow statement annexed to the Half Yearly Accounts.

ii. The aforesaid directors' loan was disclosed and described as 'long term financing received from directors' under the related parties' transactions at note 10 to the Half Yearly Accounts, even though no amount was received from directors till December 31, 2015. Hence, the related parties' transactions were, prima facie, misstated.

iii. Directors' loan of Rs.164.886 million, which is unsecured and interest free, was not appropriately accounted for at amortized cost as per requirements of International Accounting Standard IAS 39 - *Financial Instruments: Recognition and Measurement,* resulting in, prima facie, misstatement in the Half Yearly Accounts.

iv. The Company in its Half Yearly Accounts, inter alia, disclosed an investment of Rs. 2,150,490 in 35,000 shares of Pak Elektron Limited ("PEL"), which were neither shown in the CDC account balance report of the Company as at December 31, 2015 nor were those reflected in the Company's trading account with the broker, but were instead shown in the Company's CDC balance report as at January 4, 2016 i.e. subsequent to the date of Half Yearly Account. Hence, the balance of 'investment in shares of listed companies' disclosed in the Half Yearly Accounts was, prima facie, overstated by the aforesaid amount.

v. Profit and loss account annexed to the Half Yearly Accounts showed a charge of Rs. 2.139 million as 'diminution in the value of investments carried at fair value'. However, review of underlying record revealed that it was actually Rs. 1.516 million and an amount of Rs. 0.623 million, which was actually a loss incurred by the Company on trading of shares on stock exchange, was wrongly classified as diminution in the value of investments carried at fair value.

Moreover, the Company's interim financial statements for quarter ended March 30, 2016 ("Quarterly Accounts") disclosed 'loans and advances' of Rs. 321,875 given by the Company out of which Rs. 296,875 was extended to the subsidiary company HKSPL. The amount extended to HKSPL was not disclosed under the related parties' transactions causing , prima facie, omission of material facts in the Quarterly Accounts.

3. Consequently, the SCN was issued to the respondents in terms whereof they were called upon to show cause as to why penal action may not be taken against them under section 492 of the Ordinance for the aforesaid alleged misstatements in Half Yearly and Quarterly Accounts. In response to the SCN, Ahmed Bashir & Associates through letter dated September 9, 2016 requested for extension in time for submission of reply till September 30, 2016. The requested extension was allowed and the case was fixed for hearing on October 6, 2016. Subsequently, the respondents submitted written reply dated September 30, 2016. A brief of the reply relevant to the contents of the SCN is produced below:

i. The loan amounting to Rs. 15.243 million was booked in the books by debiting "Investment in HK Securities" and Crediting "Directors' Loan". As per indirect method under International Accounting Standard-7, Increase in Long Term Assets is deducted and shown in parenthesis (minus sign) in "Cash Flow from Investing Activities". Similarly Increase in Long Term Financing under indirect method is added in Cash Flows from Financing Activities with the same amount. The net effect of decrease in 'Cash Flow from Investing activities' and increase in 'Cash Flow from Financing activities' by the same amount is zero. Thus the said transaction and method of entry in the books of accounts does not make financial statement as misstated. The directors loan is a long-term liability whether paid in cash or otherwise. As the transaction was incurred, therefore, the loan was booked in accounts and loan account was credited. According to "Accrual basis of accounting concept" transaction was complete when incurred whether paid or not. The liability was neither over stated nor understated. Clearly, the financial statements were not misstated.

ii. The loan has not been amortized at cost under IAS 39 because of following reasons. The Company sold its looms back in year 2002 and since then it is striving to continue its business. The Company's administrative expenses are being paid by its directors. Management of the Company rightly treats the loan as "Interest Free and Repayable on Demand". The same does not need to be amortized according to IAS 39, as per "TR-32 issued by Institute of Chartered Accountants of Pakistan on "Accounting on Director's Loan". The contents of TR-32 are reproduced as under:

3.4.3 "In the absence of any written or other evidence characterizing the financing as a loan or a *capital contribution, the substance is likely to be regarded as an on-demand loan. The accounting is the same as for a contractual director's loan that is interest free / low interest and repayable on demand"*

3.2.2. A loan to an entity that is due on demand is a financial instrument. Upon initial recognition, a loan that is due on demand is not discounted, as it has no term and can be demanded at any time. It is recognized at full amount receivable – its face value, Although the loan is made at a non-market rate of interest and is a financing transaction, because the director can demand payment at any time, discounting from the first date when the amount could be required to be paid has no impact.

As per above quoted paras, the accounting of directors' loan in the absence of a written agreement is same as that of contractual director's loan. Therefore, the correct method of accounting was followed by the Company and any question of 'misstatement' does not arise.

iii. The investment in Pak Electron's shares was made on December 31, 2015 (Thursday) as a T+2 Transaction (which takes 2 days to settle). As per Karachi Stock Exchange's (now Pakistan Stock Exchange) notice dated November 20, 2015 pertaining to trading and settlement schedule of T+2, the settlement date was January 4, 2016 for the transactions which took place on December 31, 2015. Due to last working day which was Friday, January 1, 2016 in that week the transaction was completed on Monday, January 4, 2016. The same shares were reflected in Company's CDC statement dated January 4, 2016. As the transaction of purchase was pertaining to the period of December, 2015, it was correctly recorded in half yearly accounts. There was no 'overstatement' or 'misstatement' in the books.

iv. The amount of Rs. 2.139 million shown as diminution in value of investment was in actual Rs. 1.516 million. The remaining amount of Rs. 0.623 million was loss incurred on trading of shares. In working papers and books of accounts same amount was correctly recorded, but on face of profit and loss account as the material part was diminution in value of shares, the loss on trading of shares was clubbed with the diminution. Whether the transaction is shown separately or otherwise as clubbed in diminution, its financial impact is the same. No material error occurred and there is no misstatement in the Financial Statements.

v. The entry of Rs. 296,873/- in the books of accounts was in fact payment made to HKSPL to cover the Company's expenses pertaining to travelling, hotel bookings etc. in Islamabad.

The transaction does not reflect any trade or sale activity etc. between the two companies. This is evident from the fact that Rs. 296,873/- is an exact amount representing an expense and is too small to be advanced as a loan. The amount was mentioned under the head of 'advance' inadvertently. It does not represent any commercial/business or other activity between the two companies, therefore, it was beyond the scope of related party transactions. It is evident from the above that the Company, has not willfully and intentionally contravened sections 492 read with 476 of the Ordinance.

4. Hearing in the matter was held on October 6, 2016 and on behalf of the respondents, Mr. Ahmed Bashir, Mr. Musa Janjua and Mr. Zafar Iqbal appeared before the undersigned. They mainly reiterated the earlier written submissions and requested to conclude the proceedings without any adverse order. They further stated as under:

- It is admitted that the aforesaid directors' loan of Rs. 15.243 million against which cash was not received till December 31, 2015 should not have been included in the cash flow statement. Since the aforesaid amount was added in cash under financing activities and subtracted from cash under investing activities, therefore, net effect was nil. Moreover, under accrual basis of accounting, the liability and corresponding investment were correctly recorded.

- In respect of amortization of directors' loan, ICAP's TOR – 32 was followed and the accounting treatment was in line with TOR 32.

- It is agreed that diminution in the value of investment was in actual Rs. 1.516 million and the remaining amount of Rs. 0.623 million was loss incurred on trading of shares and should have been reported as a separate line item. However, it was a presentation error and did not affect the bottom line.

- It is agreed that the amount given to HKSPL by the Company for current expenses to be incurred on behalf of the Company by the HKSPL needed to be disclosed under related parties' transactions, however, given the nominal amount involved and its nature, it was not separately disclosed.

5. Before proceeding further, it is necessary to advert to the following relevant provisions of Ordinance, IASs and IFRS:

IAS 7- Statement of Cash Flows

Non-cash transactions

43. Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

44. Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an entity. The exclusion of non-cash transactions from the statement of cash flows is consistent with the objective of a statement of cash flows as these items do not involve cash flows in the current period. Examples of non-cash transactions are:

(a) the acquisition of assets either by assuming directly related liabilities or by means of a finance lease;
(b) the acquisition of an entity by means of an equity issue; and
(c) the conversion of debt to equity.

IAS 39- Financial Instruments: Recognition and Measurement

In terms of para 43 of IAS 39, upon initial recognition of a financial asset or financial liability, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

After initial recognition, an entity shall measure all financial liabilities at amortized cost using the effective interest method with certain exception mentioned at para 47 of IAS 39.

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 fine not exceeding five hundred thousand rupees."

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In terms of the Commission's notification SRO 1003 (I)/2015 dated October 15, 2015, the powers to adjudicate cases under section 492 of the Ordinance have been delegated to the Executive Director (Corporate Supervision Department).

6. I have analyzed the facts of the case, relevant provisions of the Ordinance, IAS and IFRS and the arguments put forth by the respondents and my observations are as under:

a) With regard to inclusion of the amount of Rs.15.243 million in the cash flow statement under the investing and financing activities despite it being a non-cash transaction, it is clear that the requirements of IAS 7 were contravened. No cash was received during the period under consideration and it was clearly a non-cash transaction whereof "directors' loan" was credited against debit to the "investment in HK Securities". IAS 7 explicitly requires exclusion of all the investing and financing transactions that do not require the use of cash or cash equivalents from the statement of cash flows. IAS 7 further clarifies that such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities. The respondents have stated that under the accrual basis of accounting liabilities and investments were correctly recognized, hence there was no misstatement. It must be noted here that the allegation on the respondents is not with regard to recording of loan liability or the investment in shares, it is rather with regard to incorrectly including the amounts in the statement of cash flows in violation of the explicit requirements of IAS 7. As a result of such violation, the cash flows from investing activities and cash flows from financing activities, which form integral parts of the statement of cash flows, were misstated.

b) Note 10 to the Half Yearly Accounts, discloses the amount of aforesaid directors' loan under the related parties' transactions with description "long term financing received from directors / sponsors". The description of the loan given in the Half Yearly Accounts under related parties transaction taken together with the entries wrongly reflected in the cash flow statement is inaccurate. It gives a wrong notion of receipt of cash / funds in shape of directors' loan, whereas in reality no funds / cash were received by the

Company and it was a non-cash transaction. Hence, it tantamount to misstatement in the Half Yearly Accounts.

c) With regard to non-compliance of requirements of IAS 39 by not accounting for the unsecured and interest free directors' loan of Rs.164.886 million, at amortized cost as per requirements of IAS 39, the respondents have given justification that the accounting treatment adopted by them in preparation of Half Yearly Accounts is in line with the TR – 32 of the ICAP. It is relevant to note that the TR – 32 was issued through circular dated January 25, 2016. The respondents have stated that in terms of TR -32, the directors' loans with no written contractual terms or on-going interest charges, are to be treated as on-demand loans. As per TR -32, on-demand loans are not to be discounted at initial recognition, as it has no term and can be demanded at any time. At the outset, it must be understood that the technical release itself clearly specifies that it is applicable for preparation of financial statements for the period beginning on or after 1 January 2016. Earlier application has only been permitted subject to proper disclosure of that fact. Since, the Company has not given any reference or disclosure with regard to TR-32 in the Half Yearly Accounts, therefore, the justification given by the respondents in the context of TR-32 is untenable. Moreover, the aforesaid directors' loan has been disclosed by the Company under "Long Term Financing", which means that there is implied understanding that the loan is not repayable by the Company in next twelve months. In the absence of any such implied terms, the Company's classification of the loan as long term would be a violation of the IFRS and would in itself be a misstatement. Moreover, para 3.4.1 and 3.4.2 of the TR-32 require the entity to make an assessment of any implied contractual terms in the absence of an explicit contract regarding terms for the repayment of the financing or any on-going interest charges. Clearly the respondents have failed to understand these explicit requirements and have rather attempted to justify their incorrect accounting treatment of directors' long term loan that is in violation of IAS 39. It is also relevant to note that the Company's auditor in its review report on the Half Yearly Accounts has rendered an adverse opinion and basis of adverse opinion, inter alia, include non-compliance with IAS-39 by not amortizing the directors' long term interest free loan. Hence, I am of the clear view that the Company's

Half Yearly Accounts do not correctly reflect the directors' loan and are misstated on this count.

d) Moreover, in terms of the law, a company is a legal person with a separate legal entity from its sponsors and members who have control of the Company. It is, therefore, responsibility of the directors and management of the Company to ensure that they duly execute agreements specifying the terms and conditions in respect of all loans obtained by the Company, including those from directors / sponsors etc. It is also imperative to have written agreements having terms and conditions to ensure that the liabilities of the Company can be appropriately determined and compliance with applicable financial reporting framework can be ensured.

e) Regarding disclosure in Half Yearly Accounts of investment of Rs. 2,150,490 in PEL's shares, which were not reflected in the Company's CDC statement as of December 31, 2015, the respondent's plea appears to be justified. The respondents' have stated that the investment was actually made on Thursday, December 31, 2015 and it took two working days for settlement on January 4, 2016, in line with the stock exchange's procedure. Due to this reason it was reflected in the CDC statement of January 4, 2016 instead of the statement of December 31, 2015. Therefore, the investment appears to have been correctly reflect in the Half Yearly Accounts.

f) With regard to incorrect clubbing of the loss of Rs. 623,000 incurred on shares' trading on stock exchange with the 'diminution in the value of investments carried at fair value' in the Half Yearly Accounts, the respondents' plea is untenable. They have stated that the financial impact remains the same irrespective of whether the transaction is shown separately or clubbed in diminution and, therefore, no material error or misstatement occurred. It must be noted that the Company was required to disclose diminution in value of investment and the loss on trading, as two separate line items, in line with the requirements of the IFRS as it was necessary for proper understanding of the users of financial statements. Moreover, considering the size of the balance sheet and profit and loss account of the Company, the amounts involved are material and should have been correctly disclosed under appropriate heads.

g) The Company's Quarterly Accounts did not disclose the amount of Rs. 296,875 given to the subsidiary company HKSPL, under the related parties' transactions in line with the requirements of IAS 24. It must be noted that all related parties' transactions are material by nature irrespective of the size. Therefore, disclosures of transactions with related parties are mandatory and cannot be skipped. The respondents have failed to ensure compliance in this regard.

h) The aforementioned non-compliances with the requirements of the IFRS including the IAS 7 and IAS 39 caused misstatements in the respective Accounts of the Company. The misstatement taken together are material vis-à-vis size of the balance sheet and profit and loss account of the Company. In the instant case, the respondents in their capacity as directors of the Company have failed to discharge their duties to follow requirements of the Ordinance and the notified IFRS, as explained above.

7. I deem it necessary to make some observations on the importance of compliance with requirements of the IFRS and the Ordinance in preparation of financial statements, adequacy and accuracy of disclosures made therein and directors' duties and responsibilities in this regard. The financial statements are the most important source of reliable information for the shareholders who make their investment decision based on such information. The financial statements not only show the financial position and performance of the company but also show the results of management's stewardship of resources entrusted to it. Therefore, adequate and correct disclosures in the financial statements in line with applicable financial reporting framework are of utmost importance. The IFRS provide basis for preparation and presentation of financial statements to ensure understandability, reliability, relevance and comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. The IFRS also set out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. Therefore, it is of utmost importance that all the applicable requirements of IFRS are complied with in letter and spirit. It is the duty of the company and its directors to see that the disclosures made in the financial statements are adequate and correct and there is no misstatement or omission of material facts. In addition to their responsibilities of overseeing and managing affairs of the Company, directors also have fiduciary duties towards the Company. They are, therefore, liable to a higher level of

accountability which requires them to be vigilant and perform their duties with care and prudence. It is directors' responsibility to oversee the functioning of the company, to keep it appropriately staffed and organized to ensure due compliance of law. In this context the respondents cannot absolve themselves of their statutory duties regarding misstatements in the financial statements.

8. For the foregoing reasons, I am of the view that the respondents are liable to be penalized under the provisions of section 492 of the Ordinance. Therefore, in exercise of the powers conferred by section 492 of the Ordinance, I hereby impose an aggregate fine of Rs. 400,000/- (Rupees four hundred thousand only) on the respondents. The respondents are directed to deposit the fines in the following manner:

Name of Respondents	Amounts in Rs.
Mr. Aurangzeb Noor, Chief Executive	50,000
Mrs. Mudassara Aurangzeb, Director	50,000
Mrs. Azmat Akbar, Director	50,000
Mr. Muhammad Waqas, Director	50,000
Mr. Irfan Noor, Director	50,000
Mrs. Sara Anjum, Director	50,000
Mr. Ali Anwar, Director	50,000
Mr. Omer Salah Ahmed, Ex-Director	50,000
Total	**400,000**

The aforesaid fines must be deposited in the designated bank account 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 aforesaid penalties are imposed on the respondents in their personal capacity; therefore, they are required to pay the said amounts from personal resources.

ABID HUSSAIN
Executive Director

Announced:
October 21, 2016
Islamabad