



[Islamabad]

Before Tahir Mahmood, Executive Director (Enforcement)

Order

In the matter of

AZAM TEXTILE MILLS LIMITED

Under Section 208 Read With Section 476 of the Companies Ordinance, 1984

Show Cause Notice No. and Date: EMD/233/90/2002
Dated May 27, 2009

Date of final hearing: January 25, 2010

Present: Mr. Mohammad Shamil, General Manager Finance
& Admin on behalf of all the directors and chief
executive of Azam Textile Mills Limited

Date of Order: May 21, 2010

This order will dispose of the proceedings initiated against the Chief Executive and Directors of Azam Textile Mills Limited (the "ATML") or (the "Company") for making unauthorized investments in shape of Loans and Advances in its associated companies in violation of the provisions of Section 208 of the Companies Ordinance, 1984 (the "Ordinance").

2. The brief facts of the case are that while examining the annual audited accounts of the Company for the year ended June 30, 2008, it was observed that the Company has advanced an amount of Rs.16.735 million (Rs. Nil: 2007) to Kohinoor Industries Limited (the "KIL"), an associated company for purchase of textile machinery (Note # 16.6 to the accounts). The Company has advanced an amount of Rs.21.910 million to KIL during the year ended June 30, 2007 for purchase of cotton.[Ref: Notes to the accounts # 20.4]. Further, analysis of subject accounts also revealed that an amount of Rs.5.031 million (Rs.0.120 million: 2007) is due from Kohinoor Power Company Limited (the "KPCL"), an associated company on account of advance and its subsequent adjustment against electric bills (Note # 20.4(b) to the accounts). Moreover, it has also been observed from the accounts of the Company that the maximum amount due from associated undertakings at the end of any month during the year stood as to Rs.19.407 million (Rs.23.473 million: 2007). [Ref. Notes to the accounts # 36.3]. The examination of quarterly accounts of the Company for the quarter



ended on December 31, 2008 further revealed that an amount of Rs.28.635 million is due from associated undertakings namely KPCL and Saritow Spinning Mills Limited .[Ref: Notes to the quarterly accounts # 11.1]. These advances prima facie were not falling in the nature of normal trade credit and appeared to be in violation of Section 208 of the Ordinance.

3. Therefore, a show cause notice dated May 27, 2009 (the “SCN”) was issued to all Directors including the Chief Executive, calling upon them to show cause as to why penal action may not be taken against them under Sub-section (3) of Section 208 read with Section 476 of the Ordinance for violating the statutory requirements of the Ordinance. A period of 14 days was given to respond to the aforesaid notice. The Company was reminded on June 17, 2009 and June 29, 2009 to respond the SCN. On July 01, 2009 Mr.Muhammad Shamil, General Manager (F&A) of the Company approached the Commission with request to provide him another copy of the aforesaid SCN as it was getting difficult for him to trace these from the record. The Copy of the SCN was provided to him on July 01, 2009.

4. The General Manager (F & A) of the Company vide letter dated July 08, 2009 responded the SCN summarized as below:

- i. The amount of Rs.16.736 million appears at Note No.16.6 clearly state that the amount is being paid for the purchase of textile machinery available for sale with Kohinoor Industries Limited, Faisalabad. The machinery is being received subsequently to terminal date of balance sheet and the advance is since being settled.

This amount does not, in any case represent investment made by our Company in associated Company. The amount is being advanced clearly to execute a business transaction at arms length. We purchase second hand machinery from Associated Company just like we may purchase from any other source.

- ii. We are purchasing electricity from Kohinoor Power Company Limited since 2001. In normal course of business and strictly in compliances with terms of agreement amount of bills are normally paid in advance and are adjusted against monthly bills. This fact is also disclosed in annual accounts for the year ended June 30, 2008.

During last year obnoxious increase in furnace oil prices it impossible for Kohinoor Power Company Limited to supply electricity at par with WAPDA. So we transfer our entire load to WAPDA. Meantime advance already paid remain unsettled on which we have charged mark-up. The amount of advance along with mark-up is being paid back by KPCL after balance sheet date.



iii. We are part of large group with three textile spinning units, electronics and power generation companies. To meet our day to day raw material requirements, we often made purchases from associates strictly in compliance with company's policy for "related parties transaction" which state Sales, Purchase and other transaction with related parties are made at arms length prices determined in accordance with the comparable uncontrolled price method.

5. The aforesaid submissions of the Company have been analysed and extending advances to the associated companies and charging mark-up to this effect is found in contravention of the provisions of Section 208 of the ordinance however, an opportunity of hearing on July 30, 2009 was granted to the Company. The General Manager (F & A) on July 28, 2009 responded the hearing notice of the Commission seeking extension in hearing date. The extension was granted and the hearing was refixed on August 24, 2009 before the undersigned. Again the General Manager (F & A) on August 19, 2009 responded the hearing notice of the Commission and on personal grounds requested extension in hearing date. Considering his request the hearing was adjourned and refixed on September 08, 2009 before the Executive Director (Enforcement).

6. The hearing was held on September 08, 2009 before the undersigned in which Mr. Muhammad Shamil, General Manager (F&A) appeared as authorized representative of respondents and reiterated the same arguments as were given in writing in response to the SCN vide above mentioned letters dated May 14, 2009 and July 08, 2009. During his explanation he added that last year due to increase in furnace oil prices and for purchase of its raw material i.e Furnace Oil the said amount was kept with KPCL for its use and the interest was charged on it. In response of certain queries regarding the approval of board of directors, receipt of machinery , interest charges on outstanding balance, the authorized representative requested to provide another opportunity of hearing which was provided on October 22, 2009. The said hearing at the request of the authorized representative vide letter dated October 20, 2009 was first rescheduled for December 10, 2009, thereafter January 11, 2010 and subsequently fixed on January 25, 2010. Mr. Shamil, appeared on the said date and stated that the company purchased machinery from KIL however the same could not be installed in the Company's Mill due to technical reasons and was thus returned and advance has been settled.

7. The authorized representative was advised to provide the following information / documents by February 05, 2010, in order to completely understand the transactions in question:-



- a) In respect of transactions with Kohinoor Power Company Limited (“KPCL”):
- i) Copy of the agreement under which electricity is being purchased from KPCL.
 - ii) Copy of the relevant approval.
 - iii) Copy of payment instrument through which the payment of deposit was made, along with copy of ledger account where the amount was booked.
 - iv) Whether or not the amount of deposit is in accordance with the normal trading practice.
 - v) Copy of balance confirmation requests received from KPCL during audit specifying the amount of deposits.
 - vi) Complete break-up, particulars of payments made to KPCL and its subsequent adjustment along with the amount of interest earned (if any) on the un-settled amount of deposit.
- b) In respect of transactions with Kohinoor Industries Limited (“KIL”):
- i) Copies of payment instruments through which payment of advance was made to KIL
 - ii) Copies of payment instruments through which payment of advance was received back from KIL
 - iii) Note reference where the assets received from KIL have been incorporated in the Company’s respective years’ financial statement.
 - iv) Note reference where the assets deletion was recorded in the accounts of KIL
 - v) Copies of the agreement made for making purchase of machinery.

8. The Company responded to the Commission’s above referred letter on February 04, 2010 seeking extension in time to submit the reply to the Commission’s letter dated February 01, 2010. The extension till February 13, 2010 was granted. The Company vide letter dated February 16, 2010 provided copy of electricity purchase agreement entered with KPCL, copy of the minutes of board of directors held on October 31, 2008, copy of current accounts ledger of the associated companies maintained in the books of accounts of ATML and explained as follows :

No deposit was maintained with KPCL in the books of Company except for brief period. Approximate payments were made in advance on day to day basis on the basis of units consumed in accordance with clause 11 of the Agreement.

The company again referred the above mentioned earlier reply submitted vide letter dated May 14, 2009, July 08, 2009 and explained that mark-up charged to KPCL has been received back subsequently which is appearing in Note No.29 to the financial accounts for the year ended June 30, 2008.

9. The information/explanation and the documents provided by the Company have been examined as follows:



Pertaining to the transactions with Kohinoor Power Company Limited (“KPCL”):-

- i. The Company failed to provide the required information about detail of purchase of electricity from its associated companies. However, the information collected from the available record describe the price of the electricity purchased by the Company from the related party in the following manners;

During the year ended on June 30, 2007	Rs.12,170,933
During the year ended on June 30, 2008	Rs. 2,086,850
During the year ended on June 30, 2009	Rs. 42,327

- ii. The Company vide its letter dated May 14, 2009 and July 08, 2009 have admitted with respect to the amount advanced to KPCL, that we are purchasing electricity from KPCL by making advance payments since long. During last year obnoxious increase in furnace oil prices it was impossible for KPCL to supply electricity at par with WAPDA. So we transfer our entire load to WAPDA. Meantime advance already paid remain unsettled on which we have charged mark-up. The amount of advance along with mark-up is being paid back by KPCL after balance sheet date.

- iii. The terms and conditions of the agreement for purchase of electricity dated September 04, 2000, made by the Company with the associated company KPCL, does not allow that in case of nonperformance, the funds in possession of KPCL shall be left at its disposal for some specified time and any interest/mark-up at some pre-defined/pre-decided rate shall be charged on the amount so invested with it.

This agreement at its clause -11 requires the Company to maintain security deposit equivalent to two months approximate bill in case specifically required by the seller on demand and the purchaser shall made the payment of electricity consumed (Units in actual) in a particular month on day to day basis in advance. The payment shall be based on units consumed by the purchaser based on its actual consumption.

In this connection, it should be noted that an open ended credit without specific purpose cannot be termed as normal trade credit. Therefore, the mere fact that the parties have covered these financial facilities by entering into a Commercial Trade Agreement would not make the financial facilities, extended, fall within the ambit of



“normal trade credit”. In my view the Company has failed to prove that the objective was for normal trade practice.

- iv. It is to mention that the examination of quarterly accounts of the Company for the quarter ended on December 31, 2008 further revealed the amount of Rs.6.943 million due from associated undertaking KPCL viz a viz the amount of Rs.5.031 million due on June 30, 2008 which exhibits the increasing trend in the loans and advances to the associated company i.e. KPCL. It is to be noted that during the year ended on June 30, 2008 the electricity purchased from associated company is of Rs.2.086 million and from July to December 2008 the bill of the electricity purchased from the associated company is of Rs.42,000 only.
- v. The copies of the ledger accounts of KPCL maintained in the books of the Company reveals that the Company is in practice of making payments on behalf of its associated Companies KPCL and others
- vi. Moreover, copies of current accounts KPCL provided by the Company reveal a continuous disbursement of cash from ATML to meet the day to day expense and make payments for purchase of raw material of KPCL. Therefore, it is apparent that the credit facilities are provided to the associated company with an intention to facilitate it financially, therefore it is clear that if trade credit facilities are provided with intention to give financial benefit, then it will not be termed as normal trade credit.
- vii. In view of the above mentioned facts, the Company has violated the provisions of the Section 208 of the Ordinance.

Pertaining to the transactions with Kohinoor Industries Limited (“KIL”):-

- i. The annual audited accounts of the Company for the year ended June 30, 2008, reflect that the Company or ATML has advanced an amount of Rs.16.735 million (Rs. Nil: 2007) to KIL, an associated company for purchase of textile machinery (Note # 16.6 to the accounts).
- ii. In the latest accounts for the year ended June 30, 2009 the amount of Rs.16.735 million advanced for purchase of machinery has been shown as recovered in the cash flow statement annexed in the accounts. The Company was required for the evidence



and approval of the aforesaid recovery but vide its letters dated January 20, 2010 and February 16, 2010 it has provided minutes of the board of directors (the “BoD”) meeting held on October 31, 2008 signed by the Chairman of the meeting as the relevant approval.

These minutes of the BoD meeting reveals that the chief financial officer (the “CFO”) of the Company explained as follows before the BoD on October 31, 2008 at the time of considering the alleged transaction of machinery in detail;

“ Our Technical Team headed by General Manager Technical visited KIL for lifting of the Frames during the month of July 2008 and on detail inspection they found that due to extra length of frames they cannot be accommodated in the existing production hall. He also explained that previously Technical Staff was of the view that they will accommodate these frames by making some adjustment in the existing production area allocated for Ring Frames. But now they are of the view that due to some other technical reasons this is not possible and they have told us not to buy these frames instead we should go for smaller frames.

He sought the approval of the board for cancellation of Agreement and received back advance from KIL”.

- iii. The minutes of the aforesaid meeting of the BoD further reflect that the board not only approved the recovery of the aforesaid amount from KIL but also took a serious note of making an arrangement on account of purchase of machinery and transferring the amount, in advance, to the associated Company without a due diligence.
- iv. In order to know the factual position the accounts of the KIL for the year ended June 30, 2008 and 2009 were reviewed. The accounts for the year ended June 30, 2008 at note 13 to the accounts revealed that KIL has provided the amount of Rs. 12.664 million as the liability directly associated with the non-current assets held for sale and remaining Rs. 4.072 million has been shown as an amount in dispute. As stated at note 12.10 to the accounts ATML for this amount have lodged claim which has not been accepted by KIL. In the accounts for the year



ended June 30, 2009 no outward flow of the cash showing decrease in advance for plant and machinery or in the concerned liability has been shown.

Further to above the KIL accounts for year ended June 30, 2009 at its note 25 describes that unsold machinery as on the balance sheet date has been entirely sold out in the period before September 30, 2009. The machinery existing on the balance sheet has been valued at its market price as the accounts are drawn up on non-going concern basis adopting the fair market value of all the assets and liabilities.

- v. According to the minutes of the BoD meeting of ATML held on October 31, 2008, it was found, in the month of July 2008 by the technical staff of ATML during the lifting of the Frames from KIL that due to extra length of frames they cannot be accommodated in the existing production hall therefore abandoning the project of purchase of machinery from KIL and to have small frames was recommended. From the accounts of KIL it can be seen that the transaction with the associated does not include plant and machinery and any change in the nature of transaction has not been discussed any where in the accounts.
- vi. The Company vide letter dated May 14, 2009 stated in its reply to the Commission pertaining to the query of amount of Rs. 16.735 million that this amount is appearing as advance to associated company KIL represents advance for purchase of machinery. The transaction is being executed subsequently. Machinery is received and advance is settled. We are maintaining normal business relation with KIL and all the transaction executed are at arms length duly verified by the auditor.
- vii. Further, the Company vide its letter dated July 08, 2009 while responding the SCN, again submitted to the Commission that the amount of Rs.16.736 million appearing at note 16.6 to the accounts clearly state that the amount is being paid for the purchase of textile machinery available for sale with KIL, Faisalabad. The machinery is being received subsequently to terminal date of balance sheet and the advance is since being settled. This amount does not, in any case represent investment made by our Company in associated Company. The amount is being advanced clearly to execute a business transaction at arms length. We



purchase second hand machinery from Associated Company just like we may purchase from any other source

- viii. From above it is evident that project for purchase of machinery from KIL has been abandon in July 2008, recovery of the amount of advance has been called by the BoD and also a serious notice to this effect is taken for obtaining machinery and transferring the amount in advance, to the associated Company without a due diligence, the Company, reported wrong misleading information to the Commission twice thorough its letters dated May14, 2009, July 08, 2009 and even by the authorized representative in the hearing before undersigned on January 25, 2010;
- ix. It has been observed that the Chief Executive and Directors of the Company, despite of the fact the BoD in their meeting held on October 31, 2008 has abandon the project however, instead of recovering the trade debts which were not in the nature of normal trade credit extended further trade credit during the year ended June 30, 2009. KIL utilized these funds with out any justified reason and requisite approval.

10. In view of the above, the said ever increasing receivables were open ended credit and cannot be termed as normal trade credit.

11. From the above stated facts, it is evident that the provisions of Section 208 of the Ordinance have been violated which requires:

“A company shall not make any investment in any of its associated companies or associated undertakings except under the authority of a special resolution which shall indicate the nature period and amount of investment and terms and conditions attached thereto.”

12. It is evident from the above facts that the said amount of advance and the credit facility extended to the associated company, cannot be termed as a normal trade credit and therefore falls under the ambit of Section 208 of the Ordinance and was extended without seeking prior approval of the shareholders through a special resolution, in violation of the requirements of Section 208 of the Ordinance and without charging any return on such credit.

13. It is pertinent to mention that board of directors acts on behalf of the shareholders to monitor their interest and has a role of decision/policy making. It delegates its authority, as the leader of the



organization, to the office of chief executive, to run the business and manage the affairs of the entity. Therefore the chief executive officer who reports to the board is not only responsible to the execution of the decision taken by the board but also as a leader of the entity assumes the role of advisor to the board of directors and simultaneously as a manager of the organization implements plans and manages financial and physical resources. In the matter placed before, the Board of Directors on October 31, 2008 took a decision and noticed a matter pertaining to the transaction of the company with its associated but the chief executive officer failed to exercise its delegated authority to recover the amount which then involved a considerable delay. As evident from the accounts of ATML no such matter was brought into the notice of the shareholders.

14. From the above stated facts and the role of the board of directors and that of chief executive it is evident that the chief executive and directors have breached their fiduciary duty by failing to exercise due diligence at the time of entering into agreement for purchasing machinery/electricity from associated companies, making advance payment for the purpose and thereafter converting the same advance into open ended trade credits to its associated companies and not recovering long outstanding interest receivables from the said associated company, granted by the Company without the authority from the shareholders and in contravention of the provisions of Section 208 of the Ordinance

15. For the foregoing reasons, it is established that the Chief Executive and the Directors have violated the provisions of Section 208 of the Ordinance and have not exercised due care while extending the said credit to the associated concern. I have, however, noted that the Directors of the Company are in a process of rectifying the default by recovering the balance of amount due from its associated companies. The Representative of the Company has also assured that Company would ensure strict compliance of the provisions of the Ordinance in future.

16. In view of the above, I, hereby impose a penalty of Rs. 500,000 (Rupees Five hundred thousand) on Chief Executive and Rs.50,000 (Rupees Fifty thousand) on each of the directors, in consequence of an investment which was made without complying with the requirements of Section 208 of the Ordinance, a further fine equivalent to the interest amount calculated below by the auditor of the Company, the directors shall jointly reimburse to the company the amount of this additional fine in an equal proportionate manner. The afore-named directors are directed to deposit the aforesaid fine in the designated bank account maintained in the name of Securities & Exchange Commission of



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
Enforcement Department

Continuation Sheet -10 -

Pakistan in the Muslim Commercial Bank Limited within 30 days of the date of this order and furnish a receipted challan to the Commission in this regard. 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.

17. Before departing with the order, it is necessary for me to issue directions regarding the aforesaid outstanding receivables from the associated companies. I deem it appropriate in the said circumstances, to invoke powers contained in Section 473 of the Ordinance and direct the Company to recover and deposit within thirty days of the date of this order in the account of the Company, the amount of outstanding receivable, including the amount of both advance and the relevant interest and for the purposes of interest computation, ATML to prepare the detailed working of interest receivable/ received so far (if any) from its associated companies KPCL and KIL since the date of making advance duly certified by the auditors containing following particulars.

Date of payment of advance	Cheque no.	Amount (Rs.)	Date of recovery	Period outstanding	Interest rate	Interest amount
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Tahir Mahmood

Executive Director (Enforcement)

Announced

May 21, 2010,

Islamabad