



Corporate Supervision Department
Company Law Division

Before Abid Hussain – Executive Director (Corporate Supervision Department)

In the matter of

Flying Board and Paper Products Limited

Number and date of notice: EMD/242/L/102/10-819-822, dated December 23, 2014
Date of hearings: March 10, 2016
Present: Mr. Musarrat Mehmood Sheikh, FCA and Mr. Mubashar Asif

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 (the “respondents”) of **Flying Board and Paper Products Limited** (the “Company”):

1. Mr. Muhammad Nazir Bhutta, Chief Executive
2. Mr. Yousaf Kamran Khan
3. Mr. Badar Mahmood
4. Mrs. Samina Kamran

These proceedings against the respondents were initiated through show cause notice (the “SCN”) dated December 23, 2014 issued under section 492 read with section 476 of the Companies Ordinance, 1984 (the “Ordinance”).

2. The brief facts of the case are that review of annual audited financial statements (the “Accounts”) for the years ended June 30, 2009 through to June 30, 2012 of the Company and perusal of other information provided by the Company revealed that the depreciation rates on fixed assets was reduced to 2% by the management with a view of increase in useful life of fixed assets of the Company. The rate of depreciation on factory assets (plant and machinery) was further reduced in the years 2011 and 2012 stating that the factory remained idle for the major part of the year 2012 and 8 months in the year 2011. The related disclosures in the respective Accounts were as under:

- (i) Accounts 2009 to 2011: ‘Summary of Significant Accounting Policies’ stated that *depreciation rates have been reduced in current year by the management with a view of increase in useful life.*
- (ii) Accounts 2011: Note 11.1 ‘Schedule of PPE’ stated that *the factory remained idle for 8 months during the current year. The management is of the view that under the usage method of depreciation, the depreciation should be charged with 60% reduction in rate on plant and machinery”.*



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- (iii) Accounts 2012: Note 12 stated that *the factory remained closed for the major part of the year, therefore, depreciation on the factory assets has been charged for the period for which the factory remained operative.*
- (iv) Accounts 2009: The Auditors' report to the members stated that *depreciation rates of fixed assets have been reduced during the year with the view of increase in useful lives of the fixed assets. Had there been no reduction in depreciation rates, the loss of the company would have been enhanced by Rs.31,837,331/- and written down values of the assets would have been decreased by the same amount.*

3. It was observed that a 'deferred cost' of Rs.40.15 million was disclosed on account of electricity expense under 'Advances, Deposits, Prepayments and Other Receivables' in the Accounts 2011 and 2012. In the Accounts 2012, under note 4 the Company recorded an addition of Rs.431.979 million in 'Surplus on Revaluation of Fixed Assets' based on the revaluation carried out on March 16, 2011. Whereas, 'Assets under Finance Lease' valuing Rs.68.767 million were not revalued along with the complete class of assets; and those were incorrectly shown as assets subject to finance lease.

4. In response to the Commission's queries in this regard, the Company vide letters dated February 26, 2014 and December 3, 2014, stated as follows:

- With regard to increase in useful life of fixed assets and auditors' qualification in Accounts 2009 it is stated that *it was due to the plant functioning below capacity and being affected severely on account outage of electricity, gas, paucity of working capital caused by consistent losses and lack of availability of raw materials.*
- With respect to deferring the cost of electricity it was stated that *the deferred cost was accounted for on account of extraordinary electricity expense which was not related to production and was shown as deferred and subject to amortization according to the revenue generation.*
- With respect to 'Surplus on revaluation of Fixed Assets' it was stated that *assets subject to finance lease amounting Rs.68,767,519/- along with accumulated depreciation Rs.54,405,053/- had been shown in owned assets in opening balances as the lease had long ago been matured and assets were incorrectly shown as subject to finance lease."*

The justification provided in aforementioned reply of the Company for increase in useful life of assets and reduction of the depreciation rates on the factory's assets were not found to be in line

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with the criteria provided by the Accounting and Financial Reporting Standards ("AFRS") for Medium Sized Entities ("MSEs").

5. Consequently, the SCN was issued to the respondents for the, prima facie, misstatements in the Accounts 2009 through to 2012, due to non-compliances with AFRS for MSEs, as stated below:

- a. Reduction in the rate of depreciation charged on fixed assets from the year 2009 through to 2011 against the criteria set forth by AFRS for MSEs. Depreciation charge on fixed assets was reduced to 2% in the years 2009 and 2010 citing the increase in useful life of assets through to 2011, depreciation rates on fixed assets was reduced to 2% by the management with a view of increase in useful life of fixed assets and it was further reduced below 2% for the factory's plant and machinery citing the reason that it remained idle for the major part of the years. The basis provided for increase in useful life of assets and reduction of the depreciation rates on the factory assets was not cogent as per the AFRS for MSEs.
- b. The electricity expense of Rs.40.15 million Accounts 2011 and 2012 was incorrectly recognized as 'Deferred Cost' by including it in 'Advances, Deposits, Prepayments and Other Receivables' instead of charging off the same to profit and loss account during the year it was incurred. The treatment was against the requirements of para 5.11 of AFRS for MSEs.
- c. The impact of revaluation of fixed assets carried out on March 16, 2011 was not incorporated in 'Surplus on Revaluation of Fixed Assets' in Accounts 2011 despite the fact that the revaluation was carried out much before the end of the financial year. Moreover, owned assets valuing Rs.68.767 million was wrongly classified as assets subject to Finance Lease and the entire class of assets was not revalued simultaneously.

6. In response to the SCN, the company through letter dated January 5, 2015 requested extension of fifteen days in time for submission of reply to the SCN. The requested extension was allowed. The respondent through letter dated January 7, 2015 requested for further extension, which was also allowed. However, the respondent failed to submit any reply within due time. The



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case was fixed for hearing on February 15, 2016 and February 24, 2016, but each time the respondents requested for adjournment. The hearing was finally held on March 10, 2016 before the undersigned and the respondents were represented by Mr. Musarrat Mehmood Sheikh, FCA and Mr. Mubashar Asif. They mainly reiterated the earlier written submissions and also made the following additional statements with reference to the contents of the SCN:

- The Company is a unlisted public company and is closely held.
- Useful life of plant and machinery of paper and board manufacturing equipment is much longer than any other plant and machinery and it does not become obsolete. Therefore, charging depreciation at 10% rate was no appropriate and charging depreciation at lower rates is justifiable.
- There were frequent shut downs of the plant due to electricity outages but now the plant is operational.
- With respect to recording of electricity expense as deferred cost, it is stated that the electricity was not used for production but was used for revival of the plant's operations. It is however, accepted that as per AFRS, the correct treatment would be charging off the electricity expense to profit and loss account in the year it was incurred.
- Revaluation should have been incorporated in preparation of Accounts 2011. But subsequently, those were incorporate in the Accounts 2012.

7. Before proceeding further, it is necessary to advert to the following relevant provisions of Ordinance and AFRS for MSEs:

AFRS for MSEs:

Section 3: Property Plant and Equipment

Para 3.26. *The depreciable amount of an item of property, plant and equipment shall be allocated on a systematic basis over its useful life. The depreciation method used shall reflect the pattern according to which the asset's economic benefits are consumed by the entity. The depreciation charge for each period shall be recognised as an expense unless it is included in the carrying amount of another asset.*

Para 3.27. *The economic benefits embodied in an item of property, plant and equipment are consumed by the entity principally through the use of the asset. However, other factors such as technical obsolescence and wear and tear while an asset remains idle often result in the diminution of the economic benefits that might*

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have been expected to be available from the asset. Consequently, all the following factors need to be considered in determining the useful life of an asset:

- a) the expected usage of the asset by the entity (usage is assessed by reference to the asset's expected capacity or physical output);
- b) the expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used, the repair and maintenance programme of the entity, and the care and maintenance of the asset while idle;
- c) technical obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or the service output of the asset; and
- d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

Para 3.33. Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases the date when the asset is derecognized. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

Para 3.19. When an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued"

Para 3.20. When an asset's carrying amount is increased as a result of revaluation, the increase shall be credited directly to the 'Surplus on Revaluation of Fixed Assets Accounts' and disclosed in the balance sheet of the entity after Capital and Reserves.

Para 5.11: When expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognized. In these cases, the expenditure is recognized as an expense when it is incurred.

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

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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."

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).

8. I have analyzed the facts of the case, relevant provisions of the Ordinance, AFRS form MSEs and the arguments put forth by the respondents and my observations are as under:

- In terms of applicable AFRS, the depreciable amount of an item of property, plant and equipment must be allocated on a systematic basis over its useful life and the depreciation method used must reflect the pattern according to which the asset's economic benefits are consumed by the entity and the depreciation charge for each period is to be recognized as an expense. While determine a suitable depreciation method and determining the depreciation expense to be charged to profit and loss accounts, several factors including the use of the asset, capacity utilization, technical obsolescence, wear and tear during idle period, technological obsolescence and legal and similar limitations must be taken into account. The Company reduced the rate of depreciation to 2% in the year 2009 stating increase in useful life of fixed asset as the reason. The auditor in his report on the Accounts 2009 has highlighted the same by stating that *had there been no reduction in depreciation rates, the loss of the company would have been enhanced by Rs.31,837,331/- and written down values of the assets would have been decreased by the same amount.* The Company further reduced the depreciation rate for plant and machinery by 60% in the years 2011 and 2012 due to lower capacity utilization. Auditors have not highlighted any concern regarding reduction in depreciation rates in the Accounts 2010 through to 2012. The schedules of 'property, plant and equipment' annexed to the Accounts reflect that the Company has not been depreciating the assets based on 'usage method', but instead has been applying the defined depreciation rates on the written down values of assets to

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allocate the depreciable amount of fixed asset over the useful life of assets. Therefore, reducing the depreciation rates further in 2011 and 2012 based on 'usage method' is not justified. It is understood that management of a company is required to assess the probability of future economic benefits of assets for determining depreciation method and charge to profit and loss account, but while doing so the management must use reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset. Furthermore, in terms of Para 12.12 of AFRS a company is required to disclose the nature and amount of a *change in an accounting estimate* that has an effect on the current period or is expected to have an effect in subsequent periods. However, the Company failed to make such disclosures which were required for understanding of the users of financial statement. Although, setting a benchmark rate of 10% as for depreciation may not be necessary, but the Company must follow consistent method of depreciation and should avoid to change it year on year basis. If after considering all the factors in terms of applicable AFRS, the Company's management thinks that the usage method is most appropriate method, it must give appropriate disclosure in the Accounts in this regard and apply the method consistently. It appears that due to inconsistent application of depreciation method over the years and lack of disclosure in this regard, the Accounts have been misstated.

- In terms of the AFRS, if the expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognized, the expenditure is required to be recognized as an expense when it is incurred. Therefore, the expense should have been charged to profit and loss account in the year it was incurred and there was no alternative available to recognize it as deferred cost. It is clear that electricity expense Rs.40.15 million, was to be charged to the profit and loss and has Company has incorrectly recognized it as 'Deferred Cost' in the Accounts 2011 and 2012. This has resulted in overstatement of 'Advances, Deposits, Prepayments and Other Receivables' and understatement of the expense for the year in which it was incurred.

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- In respect of revaluation of fixed assets, it is clear that revaluation was carried out on March 16, 2011 i.e. much before the end of financial year and it yielded a further surplus of Rs431.979 million in value of fixed assets. The revaluation carried out determines the value of the subject assets at that particular point of time. Hence, it is imperative for a company which is preparing its accounts on the revaluation model to incorporate the effects of revaluation when the revaluation report is available with it. Accordingly, the company should have incorporated the effects of revaluation in the Accounts for the year ended June 30, 2011. The non-incorporation of revaluation of fixed assets in the Accounts 2011 resulted in understatement of Surplus on Revaluation of Fixed Assets, Fixed Assets, Deferred Tax, Depreciation etc. causing misstatements in the Accounts 2011. Moreover, owned assets valuing Rs.68.767 million were wrongly classified as assets subject to Finance Lease and the entire class of assets was not revalued simultaneously. The respondents have accepted both the non-compliances citing those to be inadvertent.

9. I deem it necessary to make some observations on the importance of adequacy and accuracy of disclosures in the financial statements and directors' duties and responsibilities in this regard. The financial statements are the most important source of reliable information for the shareholders and other stakeholders. 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. 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 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 or omissions of material information in the financial statements. They also cannot avoid their responsibility of exercising due care and prudence while making investment decisions in line with the best practices, company's policy and market norms.

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10. For the foregoing reasons, I am of the view that the respondents have made themselves liable under the provisions of section 492 of the Ordinance. However, I take cognizance of the facts that the Company is a family owned unlisted public company of medium size with eleven shareholders and that the respondents have shown willingness to rectify the non-compliances. Therefore, in exercise of the powers conferred by section 492 of the Ordinance, instead of imposing maximum fines on all the respondents, I hereby impose a fine of Rs.20,000 (Rupees twenty thousand only) on the chief executive of the Company.

Other respondents are hereby warned to be careful in future regarding compliance with applicable provisions of the law. The aforesaid fine 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 penalty, proceedings for recovery of the fine as arrears of land revenue will be initiated. It may also be noted that the aforesaid penalty is imposed on the respondent in personal capacity; therefore, he is required to pay the said amount from personal resources.

Abid Hussain
Executive Director (CSD)

Announced:
April 14, 2016
Islamabad