



SECP
INSURANCE DIVISION
Islamabad

Before Hasnat Ahmad, Director (Insurance)

In the matter of

The Pakistan Mutual Insurance Company (Guarantee) Limited

Show Cause Notice Issue Date: February 21, 2014

Date of Hearing: March 11, 2015

Attended By:

1. Ch. Abdul Karim
Chief Executive
M/s. Pakistan Mutual Insurance Co. (Gte) Ltd;
2. Mr. Awais
M/s. Pakistan Mutual Insurance Co. (Gte) Ltd;
3. Mr. Hafiz M. Farooq
M/s. Pakistan Mutual Insurance Co. (Gte) Ltd.
4. Mr. Irfan Ilyas, FCA
Partner
M/s. Ilyas Saeed & Co., Chartered Accountants;

Date of Order: March 31, 2015

ORDER

Under Regulation 8(4), Regulation 9(3) and Regulation 13(1) of Part B of Annexure II of the Securities and Exchange Commission (Insurance) Rules, 2002 read with Section 156 and Section 158 of the Insurance Ordinance, 2000.

.....

This Order shall dispose of the proceedings initiated against the chief executive and directors of M/s. The Pakistan Mutual Insurance Company (Guarantee) Limited (the "Company") for alleged contravention of Regulation 8(4), Regulation 9(3) and Regulation 13(1) of Part B of Annexure II of the Securities and Exchange Commission (Insurance) Rules, 2002 (the "Regulations") read with Section 156 and Section 158 of the Insurance Ordinance, 2000 (the "Ordinance"). The chief executive and directors of the Company shall be referred to as the "Respondents" hereinafter.

SECURITIES AND EXCHANGE
COMMISSION OF PAKISTAN
Insurance Division, NIC Building,
63 Jinnah Avenue, Islamabad, Pakistan

PABX: +92-51-9207091-4, Fax: +92-51-9100428, Web: www.secp.gov.pk





A. **Background**

2. An onsite inspection of the Company was conducted on the order dated April 23, 2013, under Section 59A of the Ordinance, during which the following observations were made:

- a. **Provision for unexpired risk:** The Company did not follow 1/24th method to calculate the provision for unexpired risk for policies issued for the period of one year, as prescribed under Regulation 8(4) of the Regulations. However, instead it calculated at 40% of the total premium written during the year and considered it as the provision for unexpired risk. Thus, *prima facie* the Company did not comply with Regulation 8(4) of the Regulations;
- b. **Provision for Incurred But Not Reported Claims:** A review of the annual audited accounts of the Company for the year ended December 31, 2012 revealed that the Company did not have any practice to calculate the IBNR as required under Regulation 9(3) of the Regulations. Policy of the Company relating to recognition of claim liability was stated in the annual audited accounts as under:

"3.12 Estimated liabilities in respect of outstanding claims

Liability in respect of outstanding claims is based on certified returns of the branches and represents estimates of claims intimated or assessed before the end of the accounting year less anticipated recoveries."

- c. **Employee Benefits:** The Company was offering terminal benefits to its employees in the form of gratuity. According to the information provided by the Company to the inspection team, total gratuity earned by the employees of the Company as of December 31, 2012 was Rs. 4,839,900/-. However, the Company did not recognize the cost in the period during which the gratuity benefits were earned, in contravention of Regulation 13(1) of the Regulations and the International Accounting Standard - 19 (IAS 19). IAS 19 requires that the cost of providing employee benefits should be recognized in the period in which the benefit is earned by an employee, rather than when it is paid out or becomes payable. Whereas, the Company did not create any provision in this regard. Resultantly, the accounts did not provide true and fair picture of the status of the Company, as by this, the Company overstated its profit by not recognizing its liability and understating its expenses;
- d. **Netting off Assets & Liabilities:** The Company received cash as security deposit and got the agreements signed by its branch managers. This security deposit remained with the Company till that branch manager worked with the Company. It was then observed that when a certain branch manager resigned or left the Company for any reason, the Company returned the amount of security deposit to that particular branch manager.





However, the Company's ledger for the year 2012 was perused, and it was found that the Company netted off the security deposits from the amounts paid by the Company for various purposes such as; security deposit for telephone, for building acquired for rent etc. The Company paid Rs. 200,000/- as cash security on account of office rent during the year 2012.

The Company understated its liabilities by netting off from assets of the Company and therefore did not present true and fair picture in its financial statements. Alongside, the Company appeared to be violating para 32 of IAS 1 by offsetting its assets and liabilities, which states that:

"An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an IFRS."

3. In view of the violations highlighted in the preceding paras, the Commission initiated penal action(s) by issuance of a Show Cause Notice on February 21, 2013 to the Respondents, calling upon them to show cause as to why the fine, as provided under Section 156 and Section 158 of the Ordinance should not be imposed for non-compliance with Regulation 8(4), Regulation 9(3) and Regulation 13(1) of Part B of Annexure II of the Securities and Exchange Commission (Insurance) Rules, 2002.

4. In response to the said Show Cause Notice, the Respondents, vide their letter no. A/119/14 dated March 6, 2014, and letter no. A/49/15 dated January 27, 2015, stated that:

*"...we intend to be heard through a Counsel, who will appear on our behalf on the date of hearing as and when fixed.
...we explain as hereunder:*

1. Provisions for Un-expired Risk.

In calculating the provisions for unexpired risk, working was duly carried out under the Insurance rules and regulations of 8(2) (a) read with regulation 8(4)(b) of Part B of Annexure II of the SEC (Insurance) Rules, 2002. The un earned portion of premium income was duly recognized as a liability, and was calculated by applying the twenty-fourths method. Reconciliation statement of premium earned is attached as Annexure "A", for read reference.

The statement in notes to the accounts at note number 3.11 for the year 2012 inadvertently stated the percentage figure. The company duly applies 1/24th method for calculating provision for un-expired risk, the printing mistake/error is deeply regretted. We assure you to be careful while vetting in future.

2. Estimated liability in respect of outstanding claims:

The liability can only be determined when it is intimated to the company by the concerned Regional Transport Authority All Claims are duly reported through the





respective Regional Transport Authority and any claim which is not reported by the Authority, is not considered as a claim.

Claim is always recorded as soon as the same is intimated to the Company by the relevant DRTA/Claims Tribunal. The claim is finalized for payment after it is awarded by the Claim Tribunal. Since the company always records claims duly intimated to it by the Regional Transport Authority it is the best estimate of the claim before its final award by the Claims Tribunal. In between the lines the company is duly complying with the requirement of calculating the provision of IBNR, as reported or intimated by DRTA/Claims Tribunal. Reference may be made to the provisions of law envisaged under Sections of 49 & 67 of Motor Vehicles Ordinance, 1965.

The claims liability stated in the accounts duly accounts for unpaid reported claims, which are filed before the DRTA/Claims Tribunal. There are no claims which are incurred, but not reported. Since the company is only dealing with third party insurance, and passenger Guarantee claims which are only reported after the submission of police report, (FIR), and intimation to the Company by DRTA/Claims Tribunal, as the case may be.

Since, the company has defined settlement costs as per Thirteenth Schedule of Provincial Motor Vehicle Ordinance, 1965 (as amended) (Punjab), there is no room for estimating the provisions except accounting for settled claim, which is as per policy issued.

In light of the above it is most humbly submitted that the company is duly complying with the regulation 9(3) of the Regulations. However, in our future financial statements, we assure you of appropriate wording to our accounting policy.

3. Employee Benefits.

The company is a very Small Sized Entity, with no share capital, as per notification of SECP for adoption of "Accounting and Financial Reporting Standards for Medium Sized Entities and Small Sized Entities". There are no special provisions in AFRS for SSE to Account for employee benefits on actuarial or accrual basis.

The company has all along had the policy of recognizing employee retirement benefit (Gratuity) on payment basis, as and when it is to be actually made. The company had been applying its accounting policy consistently over the past many years, there being no outstanding liabilities, in this regard.

Without prejudice to the foregoing, it is stated that even if gratuity is being charged as expense on accrual basis, it will not effect or impact the Balance Sheet footing, neither it will hamper rights of any member of the company or will it cause loss to the State (Exchequer).

We assure you of compliance of Regulation 13(1) of the Regulation in our financial statements for the accounting period December 31, 2013.





4. Security Deposits.

While acknowledging the receipt of cash security money from the local representative it is duly declared and intimated to the rep that in respect of the security money received by the company, it has the discretion to use or utilize it in furtherance of any commercial activity without any encumbrance. Specimen acknowledgements from our different local representative are enclosed herewith as Annexure "B", for your record/reference.

Security money received and paid is grouped under the same head in the financial statements. The transaction is accounted for on accumulated net basis for all security monies received and paid. We draw reference from para 35 of IAS 1, wherein it is permissible that in case the amounts are not material, an entity may present balance on net basis."

5. Annexure - A to the abovementioned response of the Respondents regarding calculation of provision for unexpired risk, stated that:

Month	Premium	Formula	Closing balance of provision for un expired risk
January	305,624	1/24	12,734
February	225,931	3/24	28,241
March	649,909	5/24	135,398
April	1,079,373	7/24	314,817
May	1,933,432	9/24	725,037
June	2,142,744	11/24	982,091
July	1,972,457	13/24	1,068,414
August	1,385,915	15/24	866,197
September	1,474,202	17/24	1,044,226
October	1,268,409	19/24	1,004,157
November	912,734	21/24	798,642
December	851,276	23/24	815,806
Total	14,202,006		7,795,762

Reconciliation of Premium Written:

Premium Written During the Year		14,202,006
Premium reversed during the year	(114,836)	
Reinsurance premium ceded	2,229,796	
Closing balance	(7,795,762)	(5,680,802)
Opening balance		3,290,733
Premium Earned		11,811,937





6. And, Annexure - B to the aforementioned response of the Respondents it was claimed that a General Manager of the Company approached the local officers, namely, Mr. Muhammad Yaqoob (Rahim Yar Khan) and Mr. Moiz Ud Din Qureshi (Sakkar), for obtaining their consent on behalf of the Company to use these security deposits for the Company's commercial activity without any encumbrance, on which these local officers gave their consent.

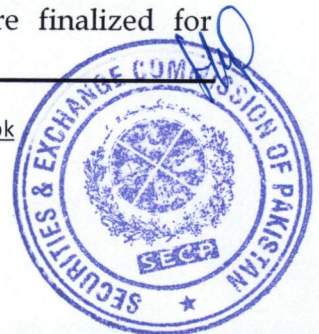
B. Hearings

7. Through the abovementioned response, the Respondents requested for a hearing to defend their stance, and accordingly the Commission, vide its notice no. ID/ENF/PMICL/2014/21234 dated November 6, 2014, scheduled the hearing for November 13, 2014 at 12:00 noon. The said hearing was adjourned on the request of the Respondents and therefore was rescheduled for January 13, 2015 at 2:30 p.m. via hearing notice no. ID/Enf/PMICL/2014/21642 dated January 1, 2015. The hearing was attended by Mr. Irfan Ilyas - Partner, M/s. Ilyas Saeed & Co., Chartered Accountants, Mr. Mubashir Raza - Manager, M/s. Ilyas Saeed & Co., Chartered Accountants, Ch. Abdul Karim - Chief Executive of the Company and Mr. Hafiz M. Farooq Afzal - Manager Finance of the Company, for and on behalf of the Respondents.

8. The Respondents gave their arguments to defend the proceedings of the Show Cause Notice during the hearing of January 13, 2015. However, the matter could not be decided on the basis of the arguments and submissions made by the Respondents. Therefore, another opportunity was provided to the Respondents, vide notice no. ID/Enf/PMICL/2015/392 dated February 26, 2015, through which hearing was scheduled for March 11, 2015 at 11:00 a.m. through video link connecting the Head Office with the Lahore Office of the Commission. The hearing was attended by Ch. Abdul Karim - Chief Executive of the Company, Hafiz M. Farooq Afzal - Manager Finance of the Company, Mr. Owais and Mr. Irfan Ilyas - Partner, M/s. Ilyas Saeed & Co., Chartered Accountants, for and on behalf of the Respondents.

9. Brief proceedings of the hearing of March 11, 2015 were as follows:

- a. The Respondents were asked to present the stance of the Company, on which they stated that their contentions have already been submitted before the Commission vide letter dated March 6, 2014;
- b. The Respondents stated that for the calculation of the provision of unexpired risk, the Regulations and 1/24th method was complied with. However, the statement at Note 3.11 in the accounts for the year 2012 was inadvertently stated and there was a printing mistake;
- c. The Respondents also stated that all claims were recorded as intimated by the relevant DRTA / Claims Tribunal and were finalized for





payment after these were awarded by the Claims Tribunal. The provision for IBNR was complied with, as there was no claim which was incurred but not reported in the light of the Motor Vehicles Laws. The Regional Transport Authority informs the Company about any claim that has arisen. It was also stated that the Company did not receive any claim during the last three years, therefore the Company was in compliance with Regulation 9(3) of the Regulations;

- d. With respect to employee's benefits scheme, the Respondents stated that the Company maintained the said scheme on payment basis i.e. as and when the payment was made, the expense was recorded in the books of accounts. The Respondents further mentioned that the Company applied its accounting policy consistently over the past many years. The Respondents conceded that the Company did not adopt IAS 19 in violation of Regulation 13(1) of the Regulation; and
- e. Lastly, the Respondents stated that the Company had the discretion to use security deposit for any commercial activity. The transaction of security money received was accounted for on accumulated net basis. There was no willful or deliberate misstatement in the Company's financial statements.

C. Issues

10. The Respondents were required to ensure compliance with Regulation 8(4), Regulation 9(3) and Regulation 13(1) of the Regulations.

Regulation 8(4) of the Regulations states that:

"(4) The unearned portion of premium income shall be recognized as a liability. Such liability shall be calculated either:

- (a) as a proportion of the gross premium of each policy, determined as the ratio of the unexpired period of the policy and the total period, both measured to the nearest day; or*
- (b) where the majority of policies are issued for one year, by applying the twenty-fourths method, whereby the liability shall equal 1/24 of the premiums relating to policies commencing in the first month of the insurer's financial year, 3/24 of the premiums relating to policies commencing in the second month of the insurer's financial year, and so on."*

Regulation 9(3) of the Regulations provide that:

"(3) The claims liability must include amounts in relation to unpaid reported claims, claims incurred but not reported, and expected claims settlement costs."





Regulation 13(1) of the Regulations states that:

"Employee Benefits: (1) Expenses related to Employee Benefits and related liabilities shall be determined in accordance with IAS 19. However, where an insurer has not adopted IAS 19 as of the date of publication of these regulations, the insurer may provide for the liability as at the end of the immediately preceding financial year in equal installments over a period not exceeding three years."

11. It has been observed that "closing balance of earned premium during the year" was exactly forty percent of the gross written premium during the year. So, it is inferred that the Company has not followed 1/24th method to calculate the provision for unexpired risk for policies issued for the period of one year. Apparently, the Respondents have recalculated the amounts in such a way to show that the Company has followed the 1/24th method as prescribed by the Regulations. In fact the Company has followed 40% method to calculate the unearned premium reserve.

12. Furthermore, the Company has no practice of calculating and accounting for the provision for incurred but not reported (IBNR) claims as required by Regulation 9(3) of the Regulations. The Company relies mainly on the claims reported for payment by the relevant authorities adjudicating the claims on account of Motor Third Party Compulsory Insurance business.

13. The Company has been offering terminal benefits to its employees in the form of gratuity without creating any provision in its financial statements, and thus, it has violated the provisions of Regulation 13(1) of the Regulations, which required that the expenses related to Employee Benefits and related liabilities should be determined in accordance with IAS 19.

14. Lastly, the Company has also been offsetting its assets and liabilities. Para 32 of IAS 1 forbids an entity to offset its assets and liabilities or income and expenses unless required or permitted by an IFRS. However, in light of para 35 of IAS 1, wherein it is permissible that in case the amounts are not material, an entity may present balance on net basis, and that the Company has submitted the "No Objection Certificates" / permissions from the relevant local officers, which have deposited the amounts with the Company as security, the Company has been found to have a legal right to offset such balances, subject to the provisions of IAS 1.

D. Summary of arguments and conclusions in respect of each issue

15. Grossly, the only argument which the Respondents relied upon was that by and large all rules and regulation have been complied with by the Company except the minor inadvertent mistakes. This argument does not coincide with the findings of the onsite inspection report. Therefore, the Company appears to have violated





Regulation 8(4), Regulation 9(3) and Regulation 13(1) of the Regulations and the International Accounting Standards, as aforesaid, and that the Company has misstated on the face of its financial statements, for which the Commission may take penal action(s) as provided under Section 156 and Section 158 of the Ordinance.

E. Overall conclusion

16. I have carefully examined and given due consideration to the written and verbal submissions of the Respondents, and have also referred to the provisions of the Ordinance and other legal references, I am of the view that the default of Regulation 8(4), Regulation 9(3) and Regulation 13(1) of the Regulations is established. Therefore, the fine as provided under Section 156 and Section 158 of the Ordinance can be imposed onto the Respondents i.e. the chief executive and directors of the Company.

17. However, before proceeding further, I find it relevant to discuss the duties of the directors. The directors, in addition to the day-to-day running of the Company and the management of its business, also have some 'fiduciary' duties i.e. duties held in trust and some wider duties imposed by statute. Hence, the directors are gauged against a higher standard of accountability which requires them to be vigilant and perform their duties with due care. In the instant case, however, the directors have failed to perform their duties with due care and prudence. As the directors are supposed to be well aware of their legal obligations in connection with the aforesaid statutory requirement of Regulation 8(4), Regulation 9(3) and Regulation 13(1) of the Regulations, therefore, it could be legitimately inferred that the default was committed knowingly and willfully.

18. After carefully examining the arguments and studying the facts and findings of the case as mentioned in the above paras of this Order, the default of the Regulation 8(4), Regulation 9(3) and Regulation 13(1) of Regulations is established, as aforesaid. Therefore, the penalty as provided under Section 156 and Section 158 of the Ordinance can be imposed onto the chief executive and directors of the Company.

19. The provisions of Section 156 of the Ordinance state that:

"Penalties. - Except as otherwise provided in this Ordinance, any insurer who makes default in complying with or acts in contravention of any requirement of this Ordinance, or any direction made by the Commission, the Commission shall have the power to impose fine on the insurer and, where the insurer is a company, any director, or other officer of the company, who is knowingly a party to the default, shall be punishable with fine which may extend to one million rupees and, in the case of a continuing default, with an additional fine which may extend to ten thousand rupees for every day during which the default continues."





20. The provisions of Section 158 of the Ordinance state that:

"Penalties. - Except as otherwise provided in this Ordinance, whoever, in any return, report, certificate, balance-sheet or other document, required by or for the purposes of any of the provisions of this Ordinance, willfully makes a statement false in any material particular, knowing it to be false, shall be punishable [by the Commission]17 with fine which may extend to one million rupees [18]."

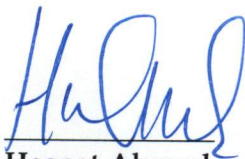
F. Penalties and directions

21. In exercise of the power conferred on me under Section 156 and Section 158 of the Ordinance, I, instead of imposing the maximum fine as provided under the said Sections, take a lenient view, and thus impose a fine of Rs. 10,000/- (Rupees Ten Thousand Only) on each of the Respondent, due to the willful default of Section 156 and 158 of the Ordinance, as mentioned hereinabove. However, in case of similar non-compliance in future, the Commission shall take stronger action against the Respondents. Further, the Respondents are hereby directed to observe strict compliance of the provisions of the Ordinance, Rules and Regulations in future. The Respondents are further directed to ensure full compliance with the Ordinance, rules, regulations and directives of the Commission in future.

22. Hence, all the Respondent are hereby directed to deposit the applicable fine in the designated bank account maintained in the name of Securities and Exchange Commission of Pakistan with MCB Bank Limited within thirty (30) days from the date of this Order and furnish receipted vouchers issued in the name of the Commission for information and record.

23. In case of failure to comply with this Order, the Commission shall be bound to initiate proceedings under Section 63(2)(d) and / or Section 65 of the Ordinance. However, in case any willful misstatement is subsequently found in the submissions made by the Respondents, the Commission shall initiate proceedings under Section 158 of the Ordinance.

24. This Order is issued without prejudice to any other action that the Commission may initiate against the Company and / or its management (including the Chief Executive Officer of the Company) in accordance with the law on matters subsequently investigated or otherwise brought to the knowledge of the Commission.



Hasnat Ahmad
Director

