



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN INSURANCE DIVISION

[Karachi]

Before Mr. Shahid Nasim, Executive Director (Insurance)

In the matter of

M/s PICIC Insurance Limited

Date of Show-Cause Notice: January 20, 2011
Date of Company's Reply: February 22, 2011
April 27, 2011
Date of Hearing: March 29, 2011
Hearing Attended By: 1. Mr. Iqbal L. Bawaney, Legal Counsel, Bawaney & Partners, Advocates;
2. Mr. Tariq Qureshi, Associate Counsel, Bawaney & Partners, Advocates;
3. Mr. Ahmed Salahuddin, Managing Director & Chief Executive Officer, PICIC Insurance Limited; and
4. Muhammad Haneed, Chief Financial Officer & Company Secretary, PICIC Insurance Limited
Date of Order: March 20, 2012

ORDER

(Under Section 158 of the Insurance Ordinance, 2000)

This Order shall dispose of the proceedings initiated against M/s PICIC Insurance Limited (hereinafter referred to as ("the Company")) for misstating the balance of Deferred Acquisition Cost (DAC) in the Annual Audited Accounts for the year ended December 31, 2009 (the "Accounts") thereby enabling the Commission to initiate proceedings under Section 158 of the Insurance Ordinance, 2000 ("the Ordinance").

Background Facts

The relevant facts for the disposal of this case are briefly stated as under:

1. The then Executive Director – Insurance has order an Onsite Inspection of the Company under Section 59A of the Ordinance, on September 6, 2010.
2. During the course of inspection, it was found that the Company's accounting policy entails division of its management expenses into two parts. The first part is



recorded as expense in proportion to the earned portion of the premium written during the period whereas the other part is recorded as an asset (that is, the Deferred Acquisition Cost (DAC)) on the face of the balance sheet in proportion of its unearned premium.

Class	Premium written	Reserve 1/24 method	%	Management Expenses Incurred	Deferred Acquisition cost
	A	B	C=B/A	D	C*D
Fire and Property Damage	122,380,397	37,184,009	30%	19,468,622	5,915,338
Marine, Aviation and Transport	106,526,895	31,329,225	29%	16,946,602	4,983,942
Motor	112,366,538	48,374,603	43%	17,875,589	7,695,570
Accident and health	78,691,128	40,930,219	52%	12,518,409	6,511,297
Miscellaneous	67,149,132	18,397,918	27%	10,682,275	2,926,794
Total	487,114,090	176,215,974	36%	77,491,498	28,032,941

4. The said accounting policy of the Company has resulted in excess and/or short reporting of the Management Expenses. A year-wise summary of the variations is given in the table below:

Particulars	2009	2008	2007	2006	2005	2004	Aggregate
Management expenses incurred	77,491	90,090	125,663	78,385	52,622	12,237	436,488
Management expenses reported	85,118	92,769	123,541	67,980	36,738	2,309	408,455
<i>Short/(Excess) reported (Deferred Acquisition Cost)</i>	<i>(7,627)</i>	<i>(2,679)</i>	<i>2,122</i>	<i>10,405</i>	<i>15,884</i>	<i>9,928</i>	<i>28,033</i>

5. The above illustrated table shows an amount of Rs.28.033 million as asset i.e. "Deferred Acquisition Cost" as on December 31, 2009, which is in fact a management expense and not directly related to the acquisition of policies like utilities, entertainment, office renovation, rent rate and taxes etc.

Following were the heads of expenses, which have been incurred and recorded as assets:

- Salaries, wages and other benefits
- Rent, rates and taxes
- Depreciation/amortization
- Reversal of provision against premiums due but unpaid
- Utilities
- Office renovation
- Repairs and maintenance
- Travelling and conveyance
- Printing and stationery
- Entertainment
- Vehicles running expenses



- Advertisement
- Computer charges
- Communication
- Others

6. It was believed that the entire amount of all expenses incurred, which were not directly related to acquisition or renewal of specific insurance policies, should have been included in the Profit & Loss Account for the year in which expenses were incurred.

7. And, based on the abovementioned fact/observations it appeared that the Company has misstated its balance sheet, which might have otherwise led the Company into insolvency, and this act of the Company was believed to be punishable under Section 158 of the Insurance Ordinance, 2000.

Show-Cause Notice

8. On January 20, 2011, a Show-Cause Notice under Section 158 of the Ordinance was issued to the Directors and Chief Executive of the Company, whereby the Company was asked to clarify their position as to why the penalty under Section 158 of the Ordinance may not be imposed onto the Company for not making misstatement in the balance sheet of the Company as at the year ended December 31, 2009, as stated above.

Company's Reply

9. The Company submitted their reply to the Show-Cause Notice through their letter of February 3, 2011. The relevant parts of the Company's reply are briefly quoted as under:

"...we would like to draw your attention towards Section 66(5) of the Ordinance which states that:

(a) acquisition costs: means such costs as may be prescribed, incurred in acquiring insurance policies and in maintaining such policies, and includes without limitation all forms of remuneration paid to insurance agents and brokers; and (underline ours)

(b) managements expenses: means all expenses incurred by an insurer, not being reinsurance expenses or claims expenses or expenses directly referable to claims, and includes without limitation acquisition costs as defined in this sub section. (underline ours)

We would also like to draw your attention towards Rule 12 of Part B of Securities & Exchange Commission (Insurance) Rules, 2002 which states that:



- (1) Commissions and other acquisition costs incurred in obtaining and recording policies of insurance and reinsurance may be deferred and recognized as assets where they can be reliably measured and it is probable that they will give rise to premium revenue that will be recognized in subsequent reporting period.
- (2) Deferred acquisition costs must be amortised systematically over the reporting periods over which the related premium revenue is recognized.
(underline ours)

From the above, it is very clear that the provisions of the Ordinance and the accounting regulations for non life insurance as contained in the Securities & Exchange Commission (Insurance) Rules, 2002 allow the deferment of commission and other acquisition costs that may be incurred in obtaining and recording of policies of insurance and reinsurance. This is essential to match the cost of acquisition of policies of insurance and reinsurance with the recognition of premium income in relation to such policies. This concept is also in line with the fundamental accounting principle of matching of cost and revenues.

It is therefore submitted that the Company's accounting policy with respect to the deferred acquisition costs is in accordance with the requirement of the applicable laws and regulations.

The Commission has not prescribed any further maximum levels of Acquisition Costs and maximum levels of Management Expenses in terms of Section 66 of the Ordinance, nor we could uncover any notification limiting the amounts of Acquisition Costs or the Management Expenses.

The Company's accounts were also audited by a renowned firm of Chartered Accountants, namely, Messrs Ernst & Young Ford Rhodes Sidat Hyder. The Auditors did not express any reservations on our accounts.

...

You will appreciate that the Auditors' Report is deemed to meet with the requirement of Section 48 of the Ordinance. Hence, we as Directors of the Company cannot be charged with the accusation of making false statement or misstatement, as stated in the SCN.

On the other hand, a perusal of Section 158 of the Ordinance leads one to a logical conclusion that it applies only to a case where a **person willfully makes a false statement in material particular, knowing it to be false** in any return report, certificate, balance sheet or other document required for the purpose of the Ordinance. In the instant case, no false statement whatsoever has been made in the balance sheet of the Company for the reasons explained above.



...

Further, we also do not agree with the Commission's view that the Company is or shall be insolvent by an amount of Rs.5,856,941/-. As regards the impact of deferment of Acquisition Cost on the computation of solvency of the Company, we would like to draw your attention towards Section 32(1) of the Ordinance which states that:

For the purposes of this Part, the following are admissible assets:

- (a) Government securities except to the extent that they are subject to any encumbrance;
- (b) assets deposited with the State Bank of Pakistan under Section 29; and
- (c) assets, other than assets referred to in clause (a) or clause (b), not specified in sub section (2) not to be admissible assets; and (underline ours)
- (d) assets, being assets referred to in clause (g) of sub section (2), in respect of which the commission has declared that those assets are to be admissible for the purposes of this Part.

You would appreciate that Section 32(1) of the Ordinance does not specifically disallow admissibility of deferred acquisition cost and therefore by virtue of para (c) of Section 32(1), it is appropriate to treat deferred acquisition cost as admissible asset.

Based on the preceding analysis, we are of the bonafide view that neither we, as the directors of the Company to whom the SCN has been issued, nor the Company has violated Section 158 of the ordinance. As such, the Show Cause Notice may kindly be discharged."

10. The abovementioned reply of the Company reveals that the Company is not aware of the amendments made in the Ordinance, as Section 32(1) of the Ordinance was misquoted by the Company wherein the amendments made to this Section vide Finance Act, 1997 were not incorporated. As on the date of this Order, Section 32(1) of the Ordinance reads as follows:

"For the purposes of this Part, the following are admissible assets:

- (a) Government securities except to the extent that they are subject to any encumbrance;
- (b) assets deposited with the State Bank of Pakistan under section 29; and
- (c) assets, other than assets referred to in clause (a) or clause (b), not specified in sub section (2); and (underline Commission's)
- (d) assets, in respect of which the commission has declared that those assets are to be admissible for the purposes of this Part. (underline Commission's)"



Therefore, in view of the above quoted Section 32(1) of the Ordinance, the plea of the Company that the Ordinance does not consider the inclusion of any assets not specified in sub-Section (2) of Section 32 of the Ordinance as admissible assets, is out rightly denied.

Since, the Deferred Acquisition Cost has not been classified as an inadmissible asset under Section 32(2) of the Ordinance nor has the Commission declared this asset as inadmissible in terms of Section 32(1)(d) of the Ordinance, therefore, it shall be considered as admissible asset in terms of Section 32(1)(c) of the Ordinance.

11. Additionally, Section 66(5) of the Ordinance clearly states that the Management Expenses include the all sorts of expenses incurred by an insurer, not being reinsurance expenses or claims expenses or expenses directly referable to claims, and includes without limitation acquisition costs as defined therein. And, the acquisition costs mean such costs incurred in acquiring and maintaining the insurance policies. So, the utilities, entertainment and other such expenses that have been treated by the Company as acquisition costs, are not incurred in acquiring and maintaining the insurance policies.

However, this is true that the Federal Government has not prescribed the costs that should have been fallen under the definition of the acquisition costs, but the definition is still quite clear in the sense that the nature of these costs has already been defined under Section 66(5) of the Ordinance.

Therefore, it cannot be inferred that all the Management Expenses are acquisition costs; however, the latter is the subset or 'part and parcel' of the former.

12. The Company further in support of its core arguments, states that one of the Director, Mr. Syed Naseer ul Hasan, has ceased to hold the office of the Director of the Company.

Here, it is pertinent to state that the names of all those Directors of the Company have been included in the Show Cause Notice, who were present at the time when the apparent anomaly was reported. Furthermore, it is not the Directors who have been accused of creating the anomaly in the Annual Audited Accounts of 2010, rather it is the insurer, and the insurer is managed by / represented by its directors, who have some fiduciary duties and are responsible for the sound and prudent management of the insurer.

13. On February 22, 2011, M/s Bawaney & Partners, Advocates & Investment & Corporate Advisers (the "Legal Counsel"), sent a letter to the Commission whereby they had requested the Commission to call the Auditors of the Company i.e. M/s Ernst & Young Ford Rhodes Sidat Hyder, Chartered Accountants, for the hearing in the matter so that the case may be decided on merit. Vide the same letter, the Legal Counsel requested for the adjournment of the hearing by one week to ten days' time.



14. On March 08, 2011, hearing notice was issued to the Company's Directors and the Chief Executive, whereby they were asked to attend the hearing on March 29, 2011 before the Executive Director (Insurance), Securities and Exchange Commission of Pakistan.

Proceedings of the Hearing & Subsequent Submissions

15. On March 29, 2011, the hearing in the matter was convened, which was attended by the following on behalf of the Company:

- i. Mr. Iqbal L. Bawaney, Legal Counsel, Bawaney & Partners, Advocates;
- ii. Mr. Tariq Qureshi, Associate Counsel, Bawaney & Partners, Advocates;
- iii. Mr. Ahmed Salahuddin, Managing Director & Chief Executive Officer, PICIC Insurance Limited; and
- iv. Muhammad Haneed, Chief Financial Officer & Company Secretary, PICIC Insurance Limited

16. Before the start of the hearing, the Legal Counsel and the Chief Financial Officer & Company Secretary of the Company submitted a 'Power of Attorney' in their favor, which was signed by six Directors of the Company, instead of seven Directors.

17. During the course of the hearing, the Legal Counsel stated:

- a. THAT the Auditors would have been called to assist the Commission during the proceedings of the hearing.
- b. THAT the Company has been following the same principle of accounting during the tenure of their previous auditor i.e. M/s A. F. Fergusons, Chartered Accountants.
- c. THAT no principle / law has been prescribed so far in order to account for the treatment of the Deferred Acquisition Cost, therefore, the companies are free to apply the General Accounting Principles as they deem fit.
- d. THAT the Auditors of the Company have endorsed / confirmed that the Company has followed the correct accounting policy in respect of the treatment for the Deferred Acquisition Cost.
- e. THAT Section 158 of the Ordinance applies to the case where the misstatement is made willfully with a malicious intention.
- f. THAT the Company has acted in a bona fide manner and that there was no mala fide intent of the Company. And, in this respect, the Legal Counsel made



references to a few cases whereby the word 'willful' was defined as an act of a person with a deliberate intent and that it was committed knowingly.

- g. FURTHER THAT there must be certain other insurance companies which have adopted the same accounting practice.

18. On behalf of the Commission, following arguments were made:

- a. THAT the comments from the Auditors of the Company will be sought in due course.
- b. THAT the Acquisition Costs are the subset of the Management Expenses.
- c. AND THAT Part B of the Securities and Exchange Commission (Insurance) Rules, 2002 clearly states that only the Acquisition Costs can be deferred, whereas the Management Expenses cannot be deferred. Therefore, in this view, only a small part of the Management Expenses can be deferred, which is actually the Acquisition Cost. However, this does not mean that a uniform percentage of each head in the Management Expenses be deferred; however, the Company was required to pick out only those expenses which can be treated as Acquisition Cost i.e. the costs which are incurred in the acquisition and maintenance of the insurance policies. The expense such as Utilities and Entertainment expenses are not adding value to the business of the Company; these expenses are the Management Expenses but not the Acquisition Costs.

19. On March 31, 2011, the Legal Counsel of the Company submitted the following four case laws, which were referred by him during the course of hearing.

- a. PLD 2005, Supreme Court, Page 30
b. A.I.R. 1929 Bombay, Page 443
c. A.I.R. 1933 Sind, Page 12, and
d. A.I.R. 1948 Calcutta, Page 190

The extract of the case laws, as highlighted by the Legal Counsel, reveals that the word 'willful' means deliberately and intentional, not accidentally or inadvertently.

20. Here, in the matter under consideration, the 'will' or the 'intent' of the Company is obvious, as by overstating the Company's assets in such a way that such assets contribute towards the solvency or insolvency of the Company. Had the Company not mention the Deferred Acquisition Cost as their asset on the face of the balance sheet, which, if considered / recognized as an asset, be classified as admissible in terms of Section 32(1)(c) of the Ordinance.

21. There are numerous insurance companies, which have maintained annual audited accounts on their official websites, all of which have setup a precedence regarding the recording and reporting of the Deferred Acquisition Costs. Except another insurance company, none of these companies have either recorded or



reported the Deferred Acquisition Costs on the face of their respective balance sheets.

22. Furthermore, PLD 2005 Supreme Court (Pages 532 – 533) states that:

“While interpreting a particular statute the preamble must be present in the mind of the Judge and where the language of the statute permits an exercise of choice or interpretation, the Court must choose the interpretation which is guided by the principles embodied therein but it does not mean that the preamble or object and reason is to be given preference and it can only be considered where the language is somewhat ambiguous. The purpose of a preamble, however, is that in case of any doubt as to the intention of the law makers it may be looked at in order to ascertain the true meaning of a particular provision but it cannot control the substantive provisions of the enactment.”

In this view, had the law maker intended to allow an insurer to defer the management expenses, instead of acquisition costs, he/she would not have given a separate definition each for the acquisition costs and the management expenses under Section 66(5) of the Ordinance. The purpose of giving separate and distinct definitions of the management expenses and the acquisition costs is to draw a line in between separating the two.

Moreover, the preamble of the Ordinance states that:

“An Ordinance to regulate the business of the insurance industry to ensure the protection of the interests of insurance policyholders and to promote sound development of the insurance industry and for matters connected therewith and therewith and incidental thereto”

In this matter, the preamble of the Ordinance adds value to the interpretation of the relevant Sections of the Ordinance pertinent to the recognition of the deferment of the Acquisition Costs and recording these costs as asset, in the sense that the Company's sunk costs if deferred and recorded as asset, will not contribute towards the Company's ability to meet its liabilities at any given point in time, which is against the interests of the insurance policyholders.

Further, PLD 2005 Supreme Court (Page 538) states that:

“A statute should be interpreted according to the plain meaning of the words and should not be given a wider meaning than what the words used would actually denote.”

And, the plain meaning of the wordings given in the Ordinance and the Rules of 2002, without considering the wider meaning of those wordings, shall mean that similar to the commissions on a particular policy, which may be deferred as and



when the premium is recognized as unearned revenue, the deferment of the acquisition costs should be done.

A cup of tea consumed at a branch of the Company has nothing to do with the acquisition, recording or maintenance of the insurance / reinsurance policies. Such an expense may be recognized as the Management Expense but not as the Acquisition Cost, and therefore, it should not be deferred and recorded as an asset on the face of the balance sheet of the Company.

23. In view of the above, the recording and reporting of the Deferred Acquisition Cost as an asset of the Company is incorrect, in the sense that the plain percentage of all the Management Expenses cannot be attributed to or linked with the life of a particular insurance / reinsurance policy, and should not have been deferred accordingly.

24. Giving the Company a fair chance to their opinion, the Commission sought the opinion of the Auditors of the Company in this respect via Commission's letter dated April 20, 2011, which was responded by the Auditors vide their letter of April 27, 2011.

The said reply of the Auditors of the Company stated that:

"...judgment is required in determining the cost incurred by an insurance company in obtaining and recording policies of insurance and reinsurance that, in terms of the SECP's Accounting Regulations, are eligible to be classified as acquisition costs and the same fact is adequately explained with reference to the Company in notes 5.5 & 6 to the financial statement. For this purpose, the Company follows a cost allocation method whereby, certain specified categories of costs that are directly attributable or may be allocated on a reasonable basis to such organizational activities which are associated with the acquisition and recording of policies of insurance and reinsurance are classified as acquisition costs (which is included under 'Management expenses' in the financial statements). All other costs incurred by the Company are recognized as period cost and have been written off in the financial statements under the 'General and Administrative expenses'. Therefore, a detailed analysis of the acquisition costs would reveal that these costs mainly include direct and indirect costs pertaining to underwriting, reinsurance and selling departments of the Company, whereas, other costs incurred in relation to functions such as claims processing, finance and accounts, information technology and administration are recognized as expense and written off in the period in which such costs are incurred. This accounting practice for identification, categorization and allocation of costs is being followed by the Company consistently over the years since its incorporation (and includes periods before our appointments as auditors) and, in our view, is consistent with the requirements of SECP's Accounting Regulations for non-life insurance companies.



In addition to the above, it would be pertinent to mention that the accounting treatment of acquisition costs as followed by the Company is also in line with accounting practices generally followed by insurance companies...

In view of the aforesaid, we are of the considered opinion that the accounting policy for deferred acquisition costs as followed by the Company is in accordance with the recognised accounting principles and practices and also comply with the requirements of the applicable laws and regulations."

In addition to the above quoted reply of the Auditors of the Company, the Auditors have sent a summary of the accounting policies being followed by Met Life Inc., Allianz Group, American Insurance Group Inc., Munich Re Group and ING Group, in respect of the Deferred Acquisition Cost.

The reply of the Auditors of the Company is somewhat contrary to what the Company is actually following.

Interestingly, the accounting policy followed by Allianz Group states (as quoted by the Auditors) that:

".....Deferred Acquisition Costs generally consist of commissions, underwriting expenses and policy issuance costs, which vary with and are directly related to the acquisition and renewal of insurance contracts. If such costs are deemed recoverable over the life of the contracts, then they are deferred accordingly....." (Underline Commission's)

In view of this, the Company has not followed the general practice in respect of the recording and reporting of the Deferred Acquisition Costs in the sense that the Company has deferred many such expenses including the Entertainment expenses which are neither directly related to the acquisition and renewal of the insurance / reinsurance contracts nor are these expenses recoverable over the life of the contracts, hence, these should not have been deferred and recorded as asset.

The accounting policy followed by Munich Re Group (as quoted by the Auditors) states that:

".....Deferred acquisition costs comprise commissions and other variable costs directly connected with acquisition or renewal of insurance contracts....

.....acquisition costs are capitalised and amortised over the duration of the contracts....." (Underline Commission's)

The abovementioned policy of Munich Re Group along with the accounting policy of American International Group Inc. and ING Group reveal that only those variable costs that are directly connected to the acquisition or renewal of the insurance contracts are considered to be the Acquisition Costs, which may be deferred and recognized as an asset.



In this view, the Company's policy is not in line with the global practice for the treatment of the Deferred Acquisition Cost.

Conclusion

25. After carefully examining the written arguments of the Company and the Auditors of the Company and studying the facts and findings of the case as mentioned in the above paras of this Order, I am of the view that the treatment of all management expenses incurred in one financial year should not be deferred as an assets to the subsequent financial years on the following reasons:

a. The Company has benefited from overstating their assets by recognizing and recording the Deferred Acquisition Costs in the proportion of the unearned portion of the premium revenue, and that the Company has taken all the Management Expenses including Utilities, Entertainment expenses etc. as their Acquisition Costs which are not directly related to the acquisition, renewal and maintenance of the insurance / reinsurance policies. Hence, the solvency of the Company has been positively affected by the accounting policy of the Company in respect of the recognition and the deferment of the Acquisition Costs;

b. The Ordinance has clearly mentioned the difference between the Management Expenses and the Acquisition Costs;

c. The global practice in respect of the recognition and the deferment of the Acquisition Costs is contrary to the Company's method of recognizing and deferring the Acquisition Costs i.e. the renowned groups are considering commissions and other variable costs as the acquisition costs, which are deferred and recognized as asset, whereas, the Company is recognizing all the Management Expenses incurred as Acquisition Costs, which are deferred and recognized as assets in the proportion of the unearned premium revenue uniformly over all the heads of these Management Expenses;

d. Case Law A.I.R. 1933 Sind (Page 12) quoted as follows:

"...what the law makes punishable is a false statement that is an untrue or incorrect statement, known to the framers of the balance sheet to be false. If there is reasonable likelihood of an honest difference of opinion, based on notions of right and wrong, correct and incorrect, mens rea cannot be attributed by the holder of one view to the holder of the opposite view. If a statement is demonstrably false, and nobody can reasonably be expected to put it forward as true, then and then only the party responsible for such a statement may be held criminally liable...."




26. Therefore, in view of the abovementioned reasons, being the first time non compliance and consideration of non clarity at the part of the company, giving an opportunity to the company to improve its presentation and compliance in future, and therefore, the penalty is not being imposed onto the Company under Section 158 of the Ordinance, which states that:

"Penalty for false statement in document.- 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, wilfully makes a statement false in any material particular, knowing it to be false, shall be punishable with imprisonment for a term which may extend to three years, or with fine which may extend to one million rupees, or with both."

Order

27. I, in exercise of powers conferred on me under Section 158 the Ordinance, instead of imposing a penalty onto the Company, take a lenient view and do not impose any fine. However, the Company and its Management is advised that the Company should adopt a transparent and fair understanding while booking and treating the expenses and deferred acquisition costs in their books of accounts and comply with the Ordinance and the principles of accounting in letter and spirit.


Shahid Nasim
Executive Director