SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
INSURANCE DIVISION

[Karachi]

Before Nasreen Rashid, Executive Director (Insurance)

In the matter of

Reliance Insurance Company Limited

Show Cause Notice Date	May 3, 2010
Date of Company Reply Letter	May 11, 2010
Date of Order	June 1, 2010

ORDER

(Under Section 158 of the Insurance Ordinance, 2000)

This Order shall dispose of the proceedings initiated against Reliance Insurance Company Limited ("the Company") for not complying with the provisions of Section 158 of the Insurance Ordinance, 2000 ("the Ordinance").

Background Facts

2. An Onsite Inspection of the Company was conducted under the Order of the Executive Director of the Insurance Division, in exercise of powers conferred under Section 59A(1) of the Ordinance, on February 1, 2010, which commenced on February 15, 2010 and completed on March 30, 2010. The Onsite Inspection Report ("the Report") was issued on April 15, 2010. According to the Report, during the course of the Onsite Inspection, it was found that, among other non-compliances, the Company had not maintained provision of Rs. 17 million in respect of FED received from policyholders, in its Financial Statements for the year ended December 31, 2008. This non-provisioning of FED resulted in a material over-statement of profits before tax, in the said published financial statements by an amount of Rs. 17 million.

3. The Report, in its Executive Summery, states that the Company had not *"maintained appropriate provision in respect of FED in the financial statements for the year ended December 31, 2008."* Due to which *"the profits before tax of the company have been over-stated intentionally by an amount of Rs. 17 million in the financial statement for the year ended December 31, 2008."*

4. According to the Report, the Onsite Inspection team discovered an anomaly while examining the Company's Sundry Creditor's. The Report states:

> *"Sundry Creditors increased from Rs. 7.032 million on December 31, 2008 to Rs. 52.754 million on December 31, 2009 registering an increase of 650%. In order to probe further in the matter, details with respect to sundry creditors were obtained and it was noted that this significant increase is due to liability booked in FY 2009, with respect to Federal Excise Duty (FED) pertaining to FY 2008 and FY 2009. The details are elaborated in the following table:"*

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5. The table referred to in the text quoted from the Report above has been reproduced below:

Sundry Creditors	FY 09-FY 08	31-Dec-09	31-Dec-08
	% Change	Rupees	Rupees
F.E.D Payable	1693%	45,109,372	2,516,146
Security Deposit Bond Guarantee	46%	3,397,169	2,330,142
F.I.F, Payable	63%	2,633,501	1,614,398
Tax Deducted at Source	100%	890,331	-
Provision for Audit Fees	36%	659,438	484,438
Interest Payable	-100%	-	87,837
P.F Loan Payable	100%	56,423	-
Tax on Salary	100%	7,966	-
Total	**650%**	**52,754,200**	**7,032,961**

6. The Report refers to the Company as RICL and states:

"It is evident from the above table that increase in sundry creditors is due to material increase in FED payable, which was increased from 2.516 million on December 31, 2008 to 45.109 million on December 31, 2009, registering an increase of 1693%. On query from the management of RICL, it was revealed that this significant increase was due to liability booking in the year ended December 31, 2009 on account of FED regarding short payments pertaining to FY 2008 and FY 2009."

7. The Report goes on to state:

"...the liability of FED pertaining to FY 2008 was a matter of concern for the inspection team as the published financial statements for the year ended December 31,2008 did not carry any provision in this regard."

8. The applicable penal provision of the Ordinance, Section 158, states:

*"**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 by the Commission with fine which may extend to one million rupees."*

Show Cause Notice

9. Accordingly, a Show Cause Notice dated May 3, 2010 under Section 158 of the Ordinance was issued to the Chief Executive and Directors of the Company, calling upon them to show cause as to why the penalty, as provided in Section 158 of the Ordinance, should not be imposed upon them for material over-statement of profits before tax, in the published financial statements for the year ended December 31, 2008, by an amount of Rs. 17 million due to non-provisioning of FED in those accounts.

Company's Response to the Show Cause Notice

10. The Company, via its letter dated May 11, 2010, in response to the abovementioned Show Cause Notice blamed it's misstatements on the semi-manual systems in place. The Company stated:

"The matter of non-provisioning of FED for the year 2008 was the worst hardship we had to face in the year 2009 just because of the semi manual working environment"

11. The Company explained:

"Our accounts department was used to prepare manual JVs and vouchers were entered & posted in general ledger in Open Office for preparation of Trail Balances where chances were always remain of posting in wrong head of accounts which also happened in our case."

12. The Company while admitting its mistake further went on to explain:

"Unfortunately we could not indentify the mistakes in year 2008 but later in year 2009 we came to know the mistake and immediately took action, rectified the records by provisioning of the un-provided FED. Non-provisioning of FED was not willfully, knowingly and intentional but a human error caused by wrong posting in accounting ledger. Nevertheless otherwise it is hereby confirmed that we rectified our records immediately once came to our knowledge under our policy of best practices. All possible efforts are being made to maintain our records with integrity, due care, prudence and professional skills."

13. The Company further went on to state that in order to avoid such errors in the future and to *"bring accuracy, efficiency and promptness"* they had engaged M/s Sidat Hyder Morshed Associates to help the Company move away from the semi manual system to expand and upgrade their technological platform and that from 2010 all operations of the Company would be on a new system.

Consideration of Company's Response

14. I have given due consideration to the written submissions of the respondents. The Onsite Inspection revealed that the Company had materially over-stated its profits by Rs.17 million due to non-provisioning of FED in the published financial accounts for FY 2008. The Company, in its response to the Show Cause Notice, while admitting their mistake, claimed it to be due to human error and the semi-manual work environment and not done willfully, knowingly and intentionally. They stated they had rectified it in FY 2009's accounts.

15. When referring to the role of the Audit Committee of the Company, also referred to as RICL in the Report, the Report states:

"Among other functions, it is the role of the Audit Committee to oversee the scope and extent of internal audit function and ensure that the internal audit function has adequate resources and is appropriately placed, ascertaining that the internal control system including financial and operational controls, accounting system and reporting structure are adequate and effective, compliance with relevant statutory requirements and risk identification and reviewing financial information. However, the Audit Committee in RICL failed to discharge their duties with due diligence. It was observed that in RICL semi manual system is placed with weak controls, which is highly vulnerable. The company is operating without significant policies and manuals; however, the Audit Committee has not taken any action in this regard, which was one of the prime responsibilities of the Audit Committee. Further, internal audit department consists of only one person who has not been provided with any job description for last two years. The inadequate staffing and scope of internal audit department have never been discussed in the Audit Committee meeting. Certain material misstatements have been highlighted by the inspection team in the financial statements for the period ended December 31, 2008 which were considered and discussed in detail by the Audit Committee. In view of the above, the role of Audit Committee cannot be termed as satisfactory"

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16. On the issue of the absence of policies and procedures, the Report states:

> *"It is interesting to note that only one policy related to under writing has been formulated by RICL since 1981. This shows the lack of interest by management of RICL with respect to formulation and implementation of policies and procedures."*

17. On the same issue, the Report further states:

> *"It appears that the management and the Board of RICL were ignorant of the very significance and importance of presence of a sound and effective internal control system in the organization. The inspection team's assertion with regard to the failure of the management's responsibilities for ensuring the establishment of an efficient control environment is vindicated by the fact that RICL had been functional without an internal control policy since its inception."*

18. It is the duty of the Company's Directors and it's Management to ensure that such gross negligence does not occur while having adequate controls & systems in place to prevent or minimize the risk of such a *"human error"* from occurring in the first place. If, such non-compliance did occur then it should not have taken an Onsite Inspection by the Securities and Exchange Commission of Pakistan ("the Commission") to discover it. The Company's own control mechanism and systems should have been so robust as to ensure that this non-compliance was dealt with quickly and effectively. The relevant extracts from the Report, stated above, clearly show how poorly the Management and Board of Directors were running the Company.

Conclusion

21. It is established that the Company had made a material misstatement in their Published Financial Statements for the year ended December 31, 2008 by an amount of Rs. 17 million. The Company and/or its officers can be held liable under Section 158 of the Ordinance due to non-provisioning of FED.

22. The Company requested that their case be decided sympathetically on the basis of their written submissions. Accordingly, the case was finalized on the basis of their written reply.

Order

23. In view of the foregoing conclusion, I, in exercise of powers conferred on me under Section 158 of the Ordinance, hereby, impose a fine of Rupees One Million (Rs. 1,000,000) on the Company.

24. *Reliance Insurance Company Limited* is hereby directed to deposit the aforesaid fine of One Million (Rs. 1,000,000) in the designated bank account maintained in the name of the Commission with MCB Bank Limited within thirty (30) days from the receipt of this Order and furnish receipted vouchers issued in the name of the Commission for information and record.

(Nasreen Rashid)
Executive Director (Insurance)