Auditing of General Insurance Companies

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There are several areas in insurance accounting and finance, both at the corporate level and operational level that need an auditor's focused attention and critical review. This article intends to deal with some of the important ones.

The Industry

General Insurance sector is next only to the banking industry in terms of importance among the economic barometers of the nation. While the banking industry is creating assets and consequently national wealth, the insurance industry is 'protecting' such wealth to the tune of several zillions of rupees. The industry is also very unique in the sense that it thrives in selling promises and marketing uncertainties and making good money in the process, cycling such money back in to the nation-building process. Cash-rich, again next only to banking, it is also the only industry that is global, both by design and default, in its reach and perspectives and hence its numbers are also massive.

The industry, which was opened up for private sector participation with a defined limit of foreign equity, after three decades of public sector monopoly, is in the process of rediscovering itself. It has become the cynosure of all discerning eyes, with more than a dozen private companies sponsored by the top industrial empires of the country teaming up with some of the best international names, have sprung in the horizon to increase the size of the cake several fold and then to take their due slices of it.

Accounts and Audit

The various stakeholders in the general insurance companies such as the Government (as the owners of the PSU companies), Indian shareholders and the JV partners (in case of private companies), policyholders, reinsurers who do business with the companies etc. consider the published financials of the Insurance Companies as the symbol of the strength and more so because such financials bear the attestation of the Chartered Accountants, who 'audit' the companies.

The excitement among Chartered Accountants that is perceptible in late March and early April in connection with Bank Audits, their eagerness to get acquainted with the latest on NPA provisioning norms and their self-propelling attitude to attend the Bank Audit seminars in huge numbers are all normally not very pronounced even among those who get the insurance audit allotments. For some unfathomable reasons, the auditors do not display any enthusiasm in acquiring the necessary domain expertise of this industry, the financial concepts of which are riddled with unique and specialized concepts such as heavy influence of the bottom lines by various estimations, statutory limitation on management expenses, relationship between the capitalizations and risk bearing capacities, protection of policyholders' interests vis-à-vis expectations of stakeholders etc. This lack of domain expertise sometimes leads to an auditor's perform-

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ing his role in lesser dimension than he normally should.

There are several areas in insurance accounting and finance, both at the corporate level and operational level that need an auditor's focused attention and critical review.

However, before embarking on the core area, let us briefly go over the metamorphosis in the area of financial reporting and disclosure requirements of general insurance companies.

Pre – IRDA scenario

The provisions of The Insurance Act, 1938 were governing the formats, reporting and disclosure requirements. Besides the financial statements in the pre-designed formats that were to be published for the benefit of the stakeholders, returns were prescribed for submission to the Controller of Insurance. On nationalization of the general insurance industry, the *de jure* supervisory authority continued to be the Controller of Insurance but the *de facto* supervisory authority was the General Insurance Corporation of India. In fact, GIC's roles were multi fold. It was the holding company, the first reinsurer, industry's policy maker, supervisor, *de facto* regulator *et al.*

Post – IRDA scenario

Came 1999, the IRDA was born. Insurance Act was suitably amended to give IRDA the powers to regulate the industry that was soon to be thrown open to private players. Among the many supplementary regulations that were issued covering many aspects of functioning, the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000 subsequently replaced by Version 2002, was the one to govern the reporting and disclosure aspects of financials of the insurance companies.

Several financial concepts came under major revision and a sea change not only in the reporting and disclosure requirements (as detailed below) but in the very area of concept of premium accounting.

- Revenue Recognition vis-à-vis URR provisioning.
- Premium Deficiency
- Investment Income bifurcation between Policyholders funds and Shareholders funds
- IBNER (Incurred but not enough reported) Claims
- Cash flow under 'Direct Method'
- Adherence to Accounting Standards with specific modifications.
- Concept of "Management Report" to stress adequate disclosures
- Auditors' report – Revision in Format.

Premium accounting

Now, to see how the financials get affected by the changes of (a) and (b) above and how the auditors so far have dealt with them can be seen below:

For time immemorial, the premium accounting was done after providing the Unexpired Risks Reserve at ad-hoc percentages indicated in the Solvency Margin requirements {Sec. 64V(1)(ii)(b)}, which were 40% for Fire, Marine Cargo & Misc and 100% for Marine Hull of "Net Premium". [However, as the Income Tax Act & Rules, allowed insurers to provide up to 50% for Fire & Misc and 100% for Marine, many insurers (and, after nationalization, all PSU insurers) took advantage of the same and so provided]. Essentially, this meant that the companies recognized the revenue, by making adjustments for URR in their Net Premium Income (Premium *less* reinsurances), calling this as Net *Earned* Premium Income.

IRDA set out to change this. In the first set of Regulations that came out in 2000, it was required that the companies recognized the Premium income over the contract period or the period of risk. Which, simply meant, *proportionately*. For example, if Rs.3,650/- is collected for a vehicle insurance policy that commenced on 18th Sept, 2003 to expire on 17th Sept, 2004, the revenue recognisable is Rs. 1,950/- for the financial year ending 31st Mar, 2004, as the policy runs its course for 195 days out of 365 days in the current financial year. The balance of Rs. 1,700/- is to be kept as unearned premium, as it is attributable and allocable to the succeeding accounting period. Perhaps, the idea germinated from the perception that in the days of high-end computers and sophisticated methods of accounting, any percentage ad-hocism in provisioning was not necessary and that the revenue accounting could be almost realistic.

IRDA's fresh set of regulations of 2002, possibly realising that the earlier Regulations on this score were found 'complicated' by the existing and the new insurers alike, sought to grant an escape route by bringing back the 'adhoc regime', by saying that though the premium recognition should still to be on 'accrual' basis, the minimum of URR should be at percentages prescribed.

However, the problem is far

from over. First of all, there is an all-important point that has been missed by the rule-framers and not also queried by rule-followers. The URR provision, basically, is on the "Net" basis. For this, only percentages, however adhoc they may seem, can work. Pro-rata recognition of revenue is possible only on "Gross" premium. This is, essentially because, the Reinsurance programmes are not policy wise, except for very major ones. They are, mostly, on treaty basis and the underwriting year for reinsurance markets will be blatantly different from the financial year basis that we might be following. The actual manner in which the whole premium accounting and RI cessions accounting works is too mind boggling to be wished away with any simplistic solutions in the name of bringing in any 'seeming realism'. Many insurers, taking advantage of the situation that 'actual accrual' can never be worked out correctly, simply continue adopting ad-hoc percentages, claiming that they are the 'minimum'.

Now, there are myriad practical problems that are encountered by the companies in recognizing the revenue but, the responsibility of auditors is to see that the Regulation is followed scrupulously or if not followed, reported accordingly. If one peruses the published annual reports of the insurance companies for 2002-03, it can be seen that most of the auditors have conveniently maintained silence on this. What is worse, some nationalized insurers have blatantly changed the rules of the game to suit their convenience during 2001-02 and 2002-03, resulting in huge difference to bottomlines, without eliciting any adverse comment from the auditors. This is perhaps the only industry, where lower business volume in a year can actually result in higher profits because of the 'reserve release' factor. Unless the auditors understand the tricks that can be played by the managements in this, it will not be possible for them to be true and fair to themselves let alone to the shareholders.

For the first time, a new concept called 'Premium Deficiency' was brought in by IRDA. Again a measure for augmenting policyholders' funds, it mandated that if the sum of expected claims costs, related expenses etc. exceed the URR, the said excess is to be recognised as Premium Deficiency. It is a fact that neither IRDA has attempted to explain the concept of this Premium Deficiency or the methodology of providing the same nor any Insurance Company really appeared to be unduly bothered on this. Some companies have opined that there was no premium deficiency in their companies while some simply 'disclosed' certain sums, even though the regulatory need was to recognize the same in accounts. However, the interesting aspect is that in most cases, the auditors have looked the other way on this issue or simply have gone by the averments made by managements in this regard.

Estimation of Outstanding Claims

The most pronounced drain of an insurance company's resources is the Claims cost (also known as Incurred Claims), which is the actual claims paid less adjustments for reinsurance recoveries on them and provisions for claims outstanding as on the date of financial reporting. On the Direct side, the operating offices of the insurance companies are expected to make the provisions based on the available information and create a liability as on the date of closing of books. The sum total of such 'direct' figures, tempered by the Reinsurance recovery adjustments and added by the Outstanding Claims figures received from the Reinsurers, in respect of 'acceptances' would be the total 'net' outstanding claims, which will form the integral and major part of the "Claims Cost". However, these are based on estimations based on information in possession of the insurance companies on the date of closing the books. Such information could include surveyor's assessments, spot survey reports, insurers' guesstimates based on the available documents and sometimes even simply on the data given, not given or short given by the claimants themselves in the claim forms. There are really no hard and fast rules on how to make these provisions and it is left to the discretion and judgment of the claims personnel as also pruning by the managements and hence unlike the URR, which will be a structured estimate, the provision for outstanding claims will always be an unstructured estimate. This not only significantly influences (sometimes, even unduly) the bottomlines but also has the potential to distort the company's liabilities in the Balance Sheet on a given date. The auditors' responsibility (both at operational office level and at the central office level) is very pronounced in this area. Only subject knowledge and experience can lead auditors right in their 'audit' of this area.

Commissions and brokerage

At the operational office level,

one of the major items of expense is the 'business procurement cost'. In the pre-IRDA days, there were agency commission payments at structured rates and though the system per se was abused to the hilt by the employees of the companies, nothing much could be done by the auditors as everything used to be alright on papers. In the post-IRDA scenario, the private insurance companies resort to ingenious methods of remunerating people, who help them procure business. Though there are official agents and brokers, the outgo towards procurement costs take different forms such as referral fee, consultancy fee etc. Unofficial rebating is also done to grease the palms of decision makers of the insureds. If auditors can be vigilant in this area, many such cases can be brought to light. The auditors, especially at the operational offices, would do well to analyse this account and seek clarifications on payments made to persons other than agents and brokers.

Current assets and liabilities

When we come to Current Assets and Current Liabilities, it will become necessary to put the concerned accounts under magnifying lens, to understand what the individual balances could broadly contain within them, as it is just possible that anything inconvenient could have been parked in the hazy sub-headlines.

For instance, every company will show both in Current Assets and Current Liabilities, the balances with "other persons/entities carrying on insurance business". Insurance, being a global business by nature, is all about spread of risks far and wide and hence every insurer parts away certain shares of his premium with other insurers, by way of co-insurance (where the preference of the customer plays a role) as well as by reinsurance, both at home and abroad. Reciprocally, he also accepts risks ceded to him. Wider the spread, better it is for all. However, such transactions between insurers (and reinsurers) mostly take place by way of correspondence and accounting entries only. While the Balance Sheet items refer to the 'net' balances as on a date, the relative effect should have gone to the revenue. There are always some transactions pending accounting for want of full information and especially when the number of transactions is huge, there can be understandable differences in balances between entities having such transactions. If periodical reconciliations take place and such pending items are accounted in the way they should be, then there will be some excuse in hiding behind the concepts such as *going concern* and *consistency*. But, in reality, such reconciliations never happen and balances are always allowed to mount, with differences ever swelling, resulting in massive sums that should have found their rightful places in the revenue accounts and in P&L accounts of the insurance companies being held captive in "capital" accounts. (For instance, a claim settled by company A on behalf of company B is debited to Company B without charging it off to Revenue and because full details are not made available, even the company B does not account it as Claim). Though, every insurance company has such transactions with hundreds of their counterparts across the globe and such problems are not unique to our country and our insurers alone, certainly it is no excuse that "Due to / Due from Insurers" continues to be a perpetual legacy of lethargy. However, in the matter of such non-reconciliation of balances, charity does not begin at home itself. There are always transactions of (a) claims settled -mostly Marine Cargo & Motor TP claims- by one office of the company on behalf of the other and (b) expenses incurred on behalf of another office. There are eternal issues of non-reconciliation between offices of the same company and at any point of time, significant amounts stand wrongly 'capitalised' in these accounts, commonly called as Inter Office Accounts.

Likewise, there is another item called as Agents' balances, both in Current Assets and in Current Liabilities. There is no official sanction in the Insurance Act or from IRDA that insurance companies can have running balances with agents. In fact, no agent is authorized to collect any money on behalf of the company. At best, there can be one month's commission dues that may stand as credit balances. Or there could be continuing aberrations of what has long since been prohibited viz., balances under Agents' bank guarantees. But, the actual extents of such balances defy such perceptions. Whether these balances are what they are really supposed to be or whether the head of account is a convenient parking place for several Para-revenue items, pending (for ever?) accounting as revenue etc. are but kept as closely guarded secrets, even from auditors, who will be constantly pressurized to complete the audits in the time frame set by the managements. Yes, the only 'reconciliation' appears to be in the attitude of the statutory auditors, as it is seen that they are reporting this as nonchalantly as possible year after year. As many of the readers of the financials

do not realize the impact, no serious questions are asked from any quarters.

Other Issues

Some of the other important issues at the operational office level are verification of compliance of Sec. 64VB of the Insurance Act, which deals with collection of premium prior to assumption of risk, bank reconciliations, operation of Bank Guarantee Premium Control account, Cash Deposit Premium Control account, refunds accounting, verification of fixed assets, cash, policy stamps etc. The Audit programme will have to factor in all of the above issues for detailed scrutiny.

Investments & Reinsurance

Audit of the investment as well as reinsurance activities happen only at the Corporate Office levels and here, the scope for auditors is well defined by the relevant Regulations of IRDA. However, the objective of the IRDA's regulations on Investments is only the protection of policyholders' funds. IRDA has stipulated that every insurer shall constitute an Investment Committee and shall draw up an annual Investment Policy which shall be placed before the Board for approval after being vetted by the Investment Committee. The Investment Policy, as approved by the Board shall also be filed with the IRDA. Schedule B of Regulation 3 of The IRDA (Preparation of financial Statements and Auditor's Report of Insurance Companies) Regulations, detailing the accounting principles for preparation of financial statements provided for the procedure for valuation of investments, provisioning and impairment norms, recognition of income, disclosures forming part of financial statements etc. which reflect the intention of the Regulators to bring in more transparency in presentation. Audit of investments will have to be a very detailed one and critical areas like 'investment in unapproved investments' (within the permissive limits), 'disinvestments' and 'selling the traded securities' etc. will have to be brought under careful scrutiny.

Reinsurance is a highly technical area and unless the auditors get very well versed in verification of Bordereaux (a spreadsheet kind statement detailing risks ceded / accepted, commissions, claims etc.), checking of quarterly statements of individual treaty reinsurers, profit commission statements etc. it may not at all be possible to do justice in this area. The one important thing that needs to be borne in mind by the auditors is that reinsurance transactions operate between companies at the international level based on a very high level of trust (concept of utmost good faith fortified) and the reinsurers place heavy reliance on the quality of the auditors who attest the financials of the Indian companies, which fact only increases the responsibility of the auditors.

Audit empanelment requirements

Prior to the private sector entry, the appointments of auditors for the four PSU companies were made by the CAG. In the current scenario where private insurers have begun operating, the appointment of auditors appears to have come within the ambit of functions of the IRDA, in terms of the regulations on preparation of financial statements and auditor's report under the IRDA Act. Here, the IRDA Act does not make any distinction between Public Sector and Private Sector Insurance Companies. (However, to what extent the said Regulations notified under the sanction given under Sec. 114 A of the Insurance Act, which in itself does not specifically state anything on auditors' appointment, can overrule the provisions of Companies Act is not clear.) Accordingly, IRDA has started compiling a panel of Chartered Accountants and for the purpose, has also prescribed certain exacting parameters for such empanelment.

Of course, in such parameters, the longevity, size etc. of a firm seem to be only given importance rather than the specialized qualifications in the field or the domain expertise of the partners. This is rather sad. An industry that is so unique and important cannot be 'audited' casually and generally, when specialization is the order of the day. Realising the importance of the need to create and develop 'domain expertise' in this industry that is all set to take a giant leap in the years to come, our Institute has newly introduced a specialized post qualification course on insurance and risk management.

Providing assurance services to the people who are themselves in the business of assuring others is a serious affair and the responsibility of the members of our profession to provide comfort (by doing 'an informed audit') to the stakeholders, regulator, reinsurers, tax authorities can hardly be overemphasized. ■