

AUDIT OF GENERAL INSURANCE COMPANIES

Question 1

Write a short note on - Incoming and Outgoing Co-insurance.

Answer

Incoming and Outgoing Co-insurance: In cases of large risks, the business is shared between more than one insurer under co-insurance arrangements at agreed percentages. The leading insurer issues documents, collects premium and settles claims. Statement of accounts is rendered by the leading insurer to the other co-insurers. The auditor should verify incoming co-insurance and outgoing co-insurance as follows:

- (i) **Incoming Co-Insurance:** The auditor should see that the Premium Account is credited on the basis of statements received from the leading insurer. In case, the statement is not received, the premium is accounted for on the basis of advices to ensure that all premium in respect of risks assumed in any year is booked in the same year. It would be advisable for the auditor to scrutinise the communication in the post-audit period and obtain a written confirmation to the effect that all incoming advices have been accounted for. The auditor should also verify claims provisions and claims paid with reference to advice received from the leading insurer.
- (ii) **Outgoing Co-Insurance:** The auditor should scrutinise the transactions relating to the outgoing business, i.e. where the company is the leader. These should be checked with reference to the relevant risks assumed under policies and correspondingly for debits arising to the co-insurer on account of their share of claims

Question 2

What are the steps to be taken while verifying the Premium of a General Insurance Company?

Answer

Verification of Premiums - Verification of premium is of utmost importance to an auditor. The auditor should apply, inter alia, the following procedures for verification of premium -

Before commencing verification of premium income, the auditor should look into the internal controls and compliance thereof as laid down for collection and recording of the premiums.

- (i) The auditor should ascertain that all the cover notes relating to the risks assumed have been serially numbered for each class of business. The auditor should also verify that there is an adequate internal check on the issue of stationery comprising of cover

notes, policy documents, stamps, etc. The auditor may apply sampling techniques for verification of larger volume of transactions.

- (ii) The auditor should ensure that premium in respect of risks incepting during the relevant accounting year has been accounted as premium income of that year on the basis of premium revenue recognition. The auditor, as part of his audit procedures, should make an assessment of the reasonability of the risk pattern established by the management. The auditor should also see whether the premium received during the year but pertaining to risk commencing in the following year has been accounted for under the head 'Premium Received in Advance' and has been disclosed separately. Normally, such instances relate to the issue of cover notes and certificates at the end of the accounting year relating to risks commencing in the next accounting period. Generally, there is a column in the Premium Register called "Commencement of Risk", indicating the date and time from which the risk under the policy issued has commenced. The auditor should verify that policy documents have not been issued, or where issued, the company was not at risk, in case:
 - (a) premium had not been collected at all;
 - (b) premium had been collected but the relevant cheques have been dishonoured
 - (c) premium had not immediately been collected due to furnishing of a bank guarantee or cash deposit but either the deposit or guarantee had fallen short or has expired or the premium had been collected beyond the stipulated time limit (i.e., there is a shortfall in bank guarantee account or cash deposit account of the insured);
 - (d) premium had not been collected due to risk cover being increased or where stipulated limits have been exhausted in respect of open declaration policies (i.e., where premium has accrued but has not been received); and
 - (e) instalments of premium have not been collected in time in respect of certain categories of policies, e.g., marine-cum-erection policies where facility has been granted for premium being paid in instalments (such facility is normally available subject to certain conditions, e.g., that the first equated instalment is more by 5 per cent of the total premium payable by instalments).
- (iii) The auditor should examine whether the reinsurance company is not under a risk in respect of amount lying at credit and outstanding as at the year-end in the following accounts:
 - (a) Deposit Premium Account;
 - (b) Premium Received in Advance Account;
 - (c) Inspectors' Deposits Account; and
 - (d) Agent's Premium Accounts

- (iv) The auditor should verify the collections lodged by agents after the balance sheet date to see whether any collection pertains to risk commencing for the year under audit. The auditor should also check that the premium has been recorded originally at the gross figure, i.e., without providing for unexpired risks and reinsurances.
- (v) In case of co-insurance business, where the company is not the leader, because of the non-availability of the relevant information in many cases the premium is not booked even though the risk has commenced during the relevant accounting year. The auditor should see that the company's share of the premium has been accounted for on the basis of the available information on nature of risk and the provisional premium charged by the leading insurer. The auditor should examine the communications issued to the company by the leading insurers advising them of the company's share of premium income. Such communications should be seen even in respect of the post-audit period. Where the company is the leader, the auditor should obtain a reasonable assurance that only the company's own share of premium has been shown as income and accounts of the other companies have been credited with their share of the premium collected.
- (vi) The auditor should check whether Premium Registers have been maintained chronologically, for each underwriting department, giving full particulars including service tax charged as per acceptance advice on a day-to-day basis. The auditor should verify whether the figures of premium mentioned in the register tally with those in General Ledger.
- (vii) Where policies have been issued with a provision to collect premium periodically (i.e., under instalment clause, special declaration policy or periodical declaration under open policies in marine insurance), the auditor should check whether premia are collected as and when they become due.
- (viii) The auditor should verify whether instalments falling due on or before the balance sheet date, whether received or not, have been accounted for as premium income as for the year under audit. Also examine whether instalments of premium falling due in the subsequent year have not been recognised in the accounts as outstanding premium.
- (ix) The auditor should verify the year end transactions to check that amounts received during the year in respect of risks commencing/ instalments falling due on or after the first day of next financial year are not credited to premium account but credited to Premium Received in Advance Account.
- (x) The auditor should verify the collections remitted by agents immediately after the cut-off date to verify the risk assumed during the year under audit on those collections.
- (xi) The auditor should also check that in case of cancellation of policies/cover notes issued, no risk has been assumed between the date of issue and subsequent cancellation thereof.

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- (xii) Where premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered.
- (xiii) The auditor should verify whether service tax has been charged from the insured, at the rates in force, on the total premium for all classes of business other than those exempted under service tax laws. Check whether service tax so collected is disclosed under 'Current Liabilities' to the extent not deposited in Government's Account.

In the case of co-insurance business, the auditor should verify whether service tax at the rates in force on the whole premium has been charged or collected from the insured by the company in case it is the leader.

Check that service tax so collected on premium charged from the insured by the company have been regularly deposited in the Government's Account.

Question 3

Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company.

Answer

Verification of Re-insurance outward

The following steps may be taken by the auditor in the verification of re-insurance outward;

- (i) The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.
- (ii) The auditor should check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
- (iii) The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.
- (iv) The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.
- (v) It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.
- (vi) It should also be seen whether the commission on cession has been calculated as per the terms of the agreement with the re-insurers.
- (vii) The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.
- (viii) The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.

- (ix) The auditor should also verify whether the Claims Paid item appears in Outstanding Claims list by error. This can be verified at least in respect of major claims.
- (x) He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.
- (xi) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.
- (xii) The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.
- (xiii) The auditor should also check that the re-insurers balance on cessions and whether the sub ledger balances tallies with the general ledger balances.
- (xiv) The auditor should review the individual accounts to find out whether any balance requires provisioning / write off or write back.
- (xv) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.
- (xvi) He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-a-vis the reinsurance inwards outstanding losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.
- (xvii) Any major event after the Balance Sheet date which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought out suitably.

Question 4

What are the specific areas to which you will give your attention while examining "Claims Paid" by a General Insurance Company.

Answer

Examination of claims paid: The auditor may determine the extent of checking of claims paid on the same line as suggested for outstanding claims. Other aspects in respect of claims paid to be examined by the auditors are as follows:

- (i) that in case of co-insurance arrangements, claims paid have been booked only in respect of company's share and the balance has been debited to other insurance companies.
- (ii) that in case of claims paid on the basis of advices from other insurance companies (where the company is not the leader in co-insurance arrangements), whether share of premium was also received by the company. Such claims which have been

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communicated after the year-end for losses which occurred prior to the year end must be accounted for in the year of audit.

- (iii) that the claims payments have been duly sanctioned by the authority concerned and the payments of the amounts are duly acknowledged by the claimants;
- (iv) that the salvage recovered has been duly accounted for in accordance with the procedure applicable to the company and a letter of subrogation has been obtained in accordance with the laid down procedure;
- (v) that the amounts of the nature of pure advances/deposits with Courts, etc., in matters under litigation/arbitration have not been treated as claims paid but are held as assets till final disposal of such claims. In such cases, full provision should be made for outstanding claims;
- (vi) that payment made against claims partially settled have been duly vouched. In such cases, the sanctioning authority should be the same as the one which has powers in respect of the total claimed amount ;
- (vii) that in case of final settlement of claims, the claimant has given an unqualified discharge note, not involving the company in any further liability in respect of the claim; and
- (viii) that the figures of claims, wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.

Question 5

State the procedure for verification of Agents' Balances in the course of audit of a General Insurance Company.

Answer

General Insurance Company – Verification of Agents' Balances: The following are the audit procedures for verification of outstanding agents' balances:

- (i) Scrutiny and review of control accounts debit balances and their nature should be enquired into.
- (ii) Examination of inoperative balances and treatment given for old balances be looked into.
- (iii) Enquiring into the reasons for retaining the old balance.
- (iv) Verification of old debit balances which may require provision or adjustment. Explanation be obtained from the management in this regard.

Question 6

"In an audit of an insurance company, the Receipts and Payments Account is also subjected to audit". Comment on this statement in brief.

Answer

Audit of Receipts and Payments Account: Section 11(1A) of the Insurance Act, 1938 provides that every insurer, in respect of insurance business transacted by him and in respect of his shareholders' funds, should prepare at the end of each financial year, a Balance Sheet, a Profit and Loss Account, a separate account of receipts and payments and a Revenue Account in accordance with the Regulations made by the IRDA. Since receipts and payments account has been made a part of financial statements of an insurer, it is implied that the receipts and payments account is also required to be audited.

The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 require that the auditor of an insurance company should:

- (i) report whether the receipts and payments account of the insurer is in agreement with the books of account and returns;
- (ii) express an opinion as to whether the receipts and payments account has been prepared in accordance with the provisions of the relevant statutes; and
- (iii) express an opinion whether the receipts and payments account give a true and fair view of the receipts and payments of the insurer for the financial year/period under audit.

It may hence be said that auditor is required to audit the Receipts and Payments Account of the insurer and also express an opinion on the same.

Question 7

What are the steps to be taken by an auditor for the audit of re-insurance ceded?

Answer

Steps in Audit of Reinsurance ceded

- (i) Evaluate internal control system in the area of reinsurance ceded to ensure determination of correct amount for reinsurance ceded, proper valuation of assets and liabilities arising out of reinsurance transaction and adherence to legal provisions and regulations.
- (ii) Ascertain whether adequate guidelines and procedures are established with respect to obtaining reinsurance.
- (iii) Reconcile reinsurance underwriting returns received from various units with the figures of premium, claims paid and outstanding claims for the company as a whole.
- (iv) Examine whether commission on reinsurance ceded is as per the terms of the agreement with the re-insurers.
- (v) Examine the computation of profit commission for automatic treaty arrangements in the light of the periodic accounts rendered and in relation to outstanding loss pertaining to the treaty.

- (vi) Examine whether loss recoveries have been claimed and accounted on a regular basis.
- (vii) Examine whether outstanding losses recoverable have been confirmed by re-insurers.
- (viii) Examine whether remittances to foreign re-insurers are as per foreign exchange regulations.
- (ix) Examine whether confirmations have been obtained regarding balances with re-insurers.
- (x) Review individual accounts of re-insurers to evaluate whether any provision/write off or write back is required.

Question 8

Write a short note on - Solvency margin in case of an insurer carrying on general insurance business.

Answer

Solvency margin in case of an insurer carrying on general insurance business Section 64VA of the Insurance Act, 1938, inter alia, requires every insurer to maintain an excess of the value of its assets over the amount of its liabilities at all times. The excess is known as 'Solvency Margin'. In the case of an insurer carrying on general insurance business, the solvency margin should be the highest of the following amounts:

- (a) fifty crore rupees (one hundred crores of rupees in case of a reinsurer); or
- (b) a sum equivalent to twenty percent of net premium income; or
- (c) a sum equivalent to thirty percent of net incurred claims,

subject to credit for reinsurance in computing net premiums and net incurred claims being actual but a percentage, determined by the regulation but not exceeding fifty percent. It may be noted that conditions regarding maintenance of the above mentioned solvency margin may be relaxed by the Authority in certain special circumstances.

If, at any time, an insurer does not maintain the required solvency margin, the insurer is required to submit a financial plan to the Authority indicating the plan of action to correct the deficiency in the solvency margin. If, on consideration of the plan, the Authority finds it inadequate, the insurer has to modify the financial plan.

Maintenance of solvency margin has a great importance for an insurance company considering their size and nature of business and also involvement of public money. Sub-section (2C) of Section 64A states that if an insurer fails to comply with the requirements of the Insurance Act, 1938, it shall be deemed to be insolvent and may be wound up by the Court.

Question 9

As per the directions under Section 619(3)(A) of the Companies Act, 1956 applicable to Insurance Companies, which are the points on which the Statutory Auditor has to report on in respect of System of Accounts?

Answer

Directions under Section 619 (3) (a) of the Companies Act, 1956, applicable to Insurance Companies in respect of System of Accounts

1. Examine the following systems and give your views as regards their deficiencies alongwith suggestions for remedial measures:-
 - (a) Recording of receipts and expenditure.
 - (b) Drawing periodical trial balance.
 - (c) Compilation of accounts.
 - (d) Reconciliation of inter-office accounts.
 - (e) Reconciliation of registers/records relating to property, assets. Investments, premiums, claims, loans, etc., with financial books.
 - (f) Maintenance of up-to-date records in respect of assets, which are pledged, encumbered or blocked in any way.
2. Are the bank accounts of the company reconciled with the bank statements regularly? If not, describe the failures.
3. Are control accounts and subsidiary accounts up-to-date and reconciled regularly? If not, describe the failures.
4. Examine the accounting policies of the company. Are these in conformity with the Accounting Standards (National and in the absence of National Standards, the corresponding International Standard)? Give particulars of material departures from these standards, if any, alongwith their effect on the financial statements; quantify the impact wherever possible.

Question 10

Write a short note on - Facultative reinsurance under Insurance Act, 1938.

Answer

Facultative Reinsurance - It is that type of reinsurance whereby the contract relates to one particular risk and is expressed in the reinsurance policy. This is the oldest method of reinsurance and it necessitates consideration of each risk separately. Each transaction under facultative reinsurance has to be negotiated individually. Each party to the transaction has a free choice, i.e., for the ceding company to offer and the reinsurer to accept. The main drawbacks of this type of insurance are the volume of work involved and time taken to cover the risk. It is, however, still used even today, mainly when:

- (i) automatic covers have already been exhausted.

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- (ii) the risk is excluded from the Treaties.
- (iii) the insurer does not want his reinsurance treaties overburdened with particularly heavy and abnormal risks.
- (iv) the insurer has no automatic cover at his disposal in a particular branch, where he issues policies rarely.
- (v) the nature of business is such that technical guidance or consultation with the reinsurer is required at every stage of acceptance of the risk itself or for a type of business where the number of risks is very small, for example, in atomic energy installations, oils rigs, etc