2012

AUDIT OF GENERAL INSURANCE COMPANIES

CHAPTER - 12

General Insurance business in India is governed by the insurance Act, 1938 which is based on British Insurance Act. GIC was formed as a government company on Nov 22, 1972.

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AUDIT OF GENERAL INSURANCE COMPANY

1. FRAMEWORK OF INSURANCE BUSINESS:

Primary legislations that deal with the insurance business in India are **insurance Act, 1938 and IRDA Act, 1999.** Various aspects relating to audit with around framework of the following statutes:

- **Insurance Act 1938**
- **IRDA Act, 1999**
- **IRDA regulations framed under IRDA Act, 1999**
- **The companies Act 1956**
- **The General Insurance Business(Nationalization) Act, 1972**

2. SOME DEFINITIONS:

SECTION	PARTCULAR	PROVISION CONATINED IN SECTION
2(9)	**INSURER**	(a) Any individual, unincorporated BOI, body corporate carrying on business which: -- **Carries on business in India** -- **Has its principal business, maintains a place of business, employ a representative.** (b) Any body corporate carrying on business of the insurance, which is **incorporated under any law for time being in force,** or stands to any such body corporate in relation of a subsidiary company. (c) Any person who has contract with underwriters who are members of the society of Lloyd's, whereby he is authorized within terms to issue **cover or any protection notes** granting insurance cover to others.
2(2)	**POLICY HOLER**	Policy holder is a person: ■ **To whom whole of interest of policy holder** ■ **Is assigned once for all**
2(7A)	**INDIAN INSURANCE COMPANY**	"An Indian insurance company means an insurer being a company-

		-- **Formed & registered under Companies Act 1956** -- **Aggregate equity share Holding by a foreign Co.** (Itself or by subsidiary or nominee) < **26%** of paid up equity capital of Indian Insurance Co. -- **Sole purpose is to** carry **LIC/GIC/Re-insurance**

IN THIS CHAPTER, I AM FIRST EXPLAINING AUDIT PROCEDURE IN RESPECT OF VARIOUS PROCESSES AND TERMS USED IN INSURANCE BUSINESS

1. ***UNDERWRITING:***

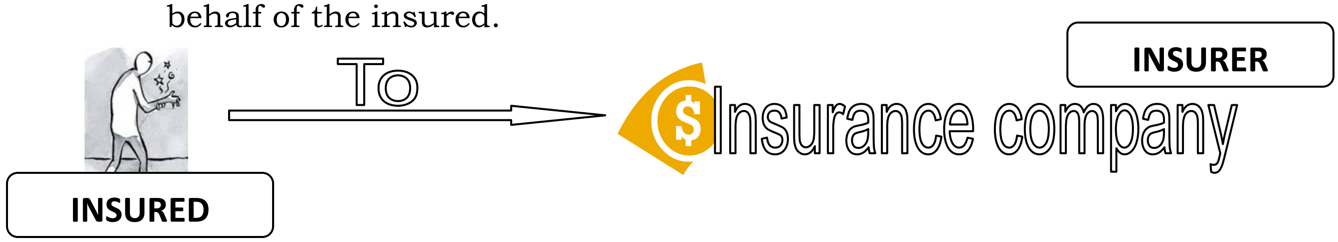
Meaning: Involves examination & evaluation of applications for insurance, risk rating and establishment of premium.

Internal Controls (Audit Point of view): ***CODE TO REMEMBER: R.-G.I.C.***

SHORT FORMS	PARTICULARS
Review of accounts	Periodic review of **suspense & un-reconciled accounts.**
Guidelines	Appropriate & clear underwriting guidelines that are communicated to **underwriting department.**
Investigation of Risk	There must be firm & effective procedure for investigation of risk assumed by the Insurance Co.
Communication among department	Effective communication between **underwriting and claim department.**

2. ***PREMIUM:***

Meaning: It is consideration received by insurer from insured under an insurance contract, whereby insurer agrees to undertake certain sum of risk on behalf of the insured.

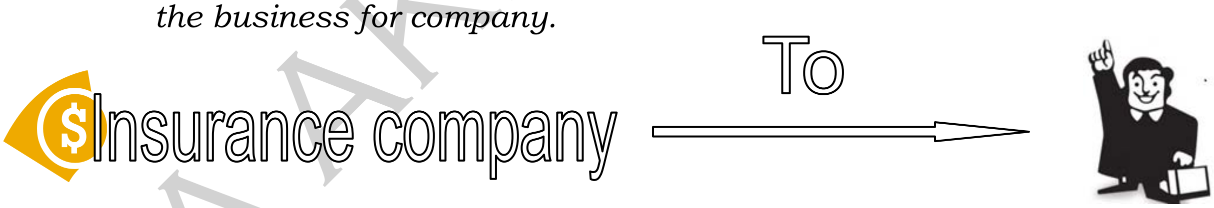


Internal Controls (Audit Point of view): **CODE TO REMEMBER: U.R.-C.A.T.S.**

SHORT FORMS	PARTICULARS
Unauthorized Transaction	Application system should be able to detect any policy transaction by unauthorized personnel
Reconciliation of Records	Maintaining & periodic reconciliation of records like **premium register, cash receipt etc.**
Calculation of Premium	Ensure that proper **premium is calculated.**
Appropriation of Income	Proper appropriation of **premium income over the time.**
Timely Entries	Ensuring the booking of **premium transactions** in a timely manner.
Suspense Balances	Suspense account balances are reviewed on timely basis.

3. *COMMISSION:*

Meaning: It is consideration payable for getting insurance business. This is the consideration payable by insurance company to its agent for bringing up the business for company.



Internal Controls (Audit Point of view): **CODE TO REMEMBER: C.A.R.**

SHORT FORMS	PARTICULARS
Calculation Of Commission	Appropriate guidelines for calculation of commission. It is to be ensured that **commission** is paid to the agent who **brought business.**
Agency Contract	Established guidelines for determining appropriate terms of **agency contract.**

Reconciliation	Appropriate system is being put in the place to ensure timey reconciliation of general ledgers.

4. *REINSURANCE:*

Meaning: *It involves* ***distribution of the risk.*** Under this, insurance is purchased by an insurance company "ceding company" from one or more other insurance companies (the "reinsurer") as a means of risk management.

"CEDING COMPANY" : An insurance company that passes the part or all of its risks from its insurance policy portfolio to a reinsurance firm.

Internal Controls (Audit Point of view): ***CODE TO REMEMBER: C.A.V.E.***

SHORT FORMS	PARTICULARS
Correct Re-insurance Amount	Ensure that there is correct amount is determined for the reinsurance ceded.
Adherence to provision	There is proper adherence to **legal provisions, regulations and reinsurance agreement.**
Valuation	Proper valuation of **assets & liabilities** is being done which is arising out of reinsurance business.
Expenses	Foreign currency exposures are correctly evaluated.

5. *CLAIMS:*

Meaning: *It involves demand for* ***payment of policy benefit*** *because of occurrence of an* ***insured event.***

Internal Controls (Audit Point of view): ***CODE TO REMEMBER: U-C.B.S.E.***

SHORT FORMS	PARTICULARS
Unpaid Claims	Regular reconciliation of **unpaid claims** and general ledger.

Cases settled	All settled cases are recorded as closed in a timely manner.
Budgeted	Significant variances between **expected and actual claims** are identified and investigated.
Suspense	Suspense account is reviewed periodically.
Expert Requirement	**Specialists** like actuaries, lawyers **etc** are consulted where circumstances required.

OPERATING EXPENSES:

Meaning: *All the operating expenses of an insurance company is being classified under 13 heads in **schedule 4.***

Certain requirements in case of operating expenses:

1. **Schedule 4** forms part of the **revenue account** of insurance business.
2. **Any other expenses** are being grouped under head **"others".**

Revenue Account for the year ended 31st March, 20....

(To be prepared separately fire, marine, and miscellaneous insurance)

Particulars	*Schedule*	*Current year (₹ '000)*	*Previous year (₹ '000)*
1. Premiums earned (Net)	1		
2. Profit/Loss on sale/redemption of investments			
3. Others (to be specified)			
4. Interest, Dividend & Rent-Gross			
Total (A)			
1. Claims incurred (Net)	2		
2. Commission	3		
3. Operating Expenses related to Insurance Business	4		
4 Others – To be specified			
Total (B)			

3. **Any major expenses** i.e. **5,00,000 or in excess of 1% of net premium** are required to be shown separately.

4. Other thing that has to be considered is “expenses related to insurance business” that means **expenses which are not related to insurance business** are to be shown separately in **profit & loss account.**

5. **Indirect** expenses are first aggregated and then it is apportioned to **the revenue account.**

6. Basis of such apportionment must be indicated by way of disclosure of the **accounting policies.**

LEGAL AND PROFFESSIONAL CHARGES:

DISCLOSURE: *It has to be disclosed in the **SCHEDULE 2** under head **“Claims incurred”.***

Points to remember:

a. Charges of survey, fees, legal & other expenses should form part of claim cost & as such **not be recorded** under legal and professional charges.

b. As such all expenses which are not part of claim cost will come under the head “legal and professional charges”.

Particulars
Claims paid
Direct
Add: Reinsurance accepted
Less: Reinsurance Ceded
Net Claims paid
Add claims Outstanding at the end of the year
Less Claims Outstanding at the beginning
Total Claims Incurred

PROVIDING THIS TABLE SO AS TO SHOW STUDENTS THE PRACTICALITY WITH THEORITICAL PART

Notes:

(c) The surveyor fees, legal and other expenses shall also form part of claims cost.

EMPLOYEES RUMNERATION AND WELFARE BENEFITS:

DISCLOSURE: *It includes **all kinds of payment** made to employees in connection of their services.*

Points to remember:

a. Reimbursement of **medical expenses or premium in respect of employees** health cover is covered under this head.

b. Medical fees paid towards **maintenance of health care policies** (Not for employees) are **required to be debited to CLAIM COST,** since it is paid for the policy holder but ***not employee.***

INTEREST AND BANK CHARGES:

DISCLOSURE: *It includes expensed towards **maintenance of bank account, interest & other charges levied by** bankers in normal course of insurance business.*

*It is shown under the head **"Interest and Bank Charges" under SCHEDULE 4.***

Points to remember:

a. Any other interest charged on borrowing which don't form part of the revenue account **not to be included under this head.**

DEPRECIATION:

DISCLOSURE: *Rates of depreciation are governed by provisions of the Companies act 1956. Shown under **"SCHEDULE 4".***

INTEREST, DIVIDEND & RENT:

DISCLOSURE: An insurance company earns interest, dividend & rent through its assets.

Points to remember:

a. Interest, dividend & rent are to be apportioned between **revenue account & profit & loss account.**

b. Required basis of **allocation of** Interest, dividend & rent.

c. Interest or dividend **earned against policyholder's funds** is required to be apportioned to **revenue account.**

d. *Interest or dividend --- **earned on shareholder funds** --- Revenue Account.*

e. Interest earned **on grant of home, vehicle loan, rent received from property** of the company etc --- **Shown in PROFIT & LOSS Account.**

Revenue Account for the year ended 31st March, 20....

Particulars	*Schedule*	*Current year (₹ '000)*	*Previous year (₹ '000)*
1. Premiums earned (Net)	1		
2. Profit/Loss on sale/redemption of investments			
3. Others (to be specified)			
4. Interest, Dividend & Rent-Gross			

Particulars	*Schedule*	*Current year (₹ '000)*	*Previous year (₹ '000)*
1. Operating Profit/(Loss)			
(a) Fire Insurance			
(b) Marine Insurance			
(c) Miscellaneous Insurance			
2. Income from investments			
(a) Interest, Dividend & Rent - Gross			
(b) Profit on sale of investments			
Less: Loss on sale of investments			

AUDIT OF REVENUE ITEMS:

1. *Premium:*

Premium shall be recognized an income **over the contract period or the period of risk,** whichever is appropriate.

Premium Received in advance **:** Not related to current period, shall be disclosed separately under the head **"Current Liability"**

Unreserved Risk reserve **:** Reserve should be created, amount representing that **part of premium** which is attributable to the succeeding years.

Premium Deficiency **:** Expected claim cost **>** Unearned premium

2. *Claims:*

Component of the **ultimate cost of claims** to an insurer **comprise the claims** under policies & settlement costs.

Liability for claims may arise on ---

1. Direct business
2. Inward Reinsurance Business
3. Co Insurance Business

Liability may also arise because of -

1. Future claims of unreported claims.
2. Claims incurred but not reported.

AUDIT OF BALANCE SHEET ITEMS:

Following are broad classification of items in a balance sheet-

I. INVESTMENT:

- Legal requirement for investment contained in **section 27B, C and D.**
- Section 27B : **No insurer carrying on general business insurance** can invest / keep invested **any parts** of its assets

- An insurer invest/keep invested nay parts of its assets otherwise than in approved investment, if following conditions are satisfied:
  a. **Such investment not exceeds 25% of total investment.**
  b. **Such investments are made with the consent of all directors.**

- Sec- 27B(4) : **Insurer should not invest/ keep invested** parts of its assets in the Shares of **any insurance company** or **investment company** which

  Constitute **>** **10%** of total assets of insurer **OR**
  2% of subscribed share capital/ debentures

- Section 27C : Prohibit **insurer** from **investing, directly or indirectly, FUNDS** of policyholder **outside INDIA.**

AUDIT PROCEDURE in respect of investment:

CODE TO REMEMBER: **B.D.P. - I.D.T.** (**B**a**D**ar**P**ur par **I.D.T.** studied)

CODES	**PARTICULARS**
Branch Visit	Examine records for investment held at branches & request certificate of the investment.
Demat form of investment	Obtain **separate lists of securities** held ***physically and in DEMAT form.***
Physically Verification	Physically verify **securities** on the **balance sheet date.** Auditor must prepare a **reconciliation statement** where verification on date other than balance sheet date.

Income from Investment	Examine whether **income from investment** is properly accounted for.
Disclosure Requirement	Examine the norms relating to **valuation & disclosure** in financial statements has been complied with.
TDS certificate	Ensure that **certificates** of **TDS** are properly maintained.

II. CASH & BANK BALANCE:

CODE TO REMEMBER: **B - C.P.T.**

CODES	**PARTICULARS**
Bank Reconciliation statements	Auditor must trace subsequent realization of items appearing in bank reconciliation statement.
Confirmation of balances	He should obtain **confirmation** of the year end balances.
Physical Verification	Auditor should verify **cash balances at the year end.**
Test Check	Auditor should test check the bank transactions.

III. OUTSTANDING PREMIUM AND AGENT'S BALANCE:

CODE TO REMEMBER: **I.D.E.A.**

CODES	**PARTICULARS**
Inoperative Balances	Examine **inoperative** balances & treatment given for old balances.
Debit Balances (old)	Verify **old balances** which may require provisions or adjustments.

Enquiry	Enquire the reason for retaining the **old balances.**
Analysis	Analysis of **outstanding premium** age-wise & sector wise.

IV. PROVISION FOR TAXATION:

CODE TO REMEMBER: **W.S. - P.F.T.**

CODES	**PARTICULARS**
Wealth Tax	Auditor should assess the **implication of wealth tax ACT 1957.**
Service Tax	Auditor must assess the **service tax collection** system & payments to statutory authorities & filing of returns.
Provision calculation	Auditor must ensure that provision of taxation is being provided by considering specific provisions **related to General Insurance Company.**
Foreign Incomes	Auditor should examine **income of foreign branch** & foreign countries & whether the provisions of **double taxation avoidance agreement** have been considered.
TDS	Auditor should see that all **TDS** certificates have been kept and deduction on the dame is claimed.

V. UNEXPIRED RISKS RESERVES:

It is obvious that all **polices** doesn't expire on **a particular date.** Some policies get extend beyond this date. So, at the time of closing of accounts, there is **un-expired liability** under various policies.

As per **Insurance Act 1938,** the provision is made for unexpired risks:

a. 50% for **marine Cargo & Miscellaneous Business.**
b. 100% for **Marine Hall.**

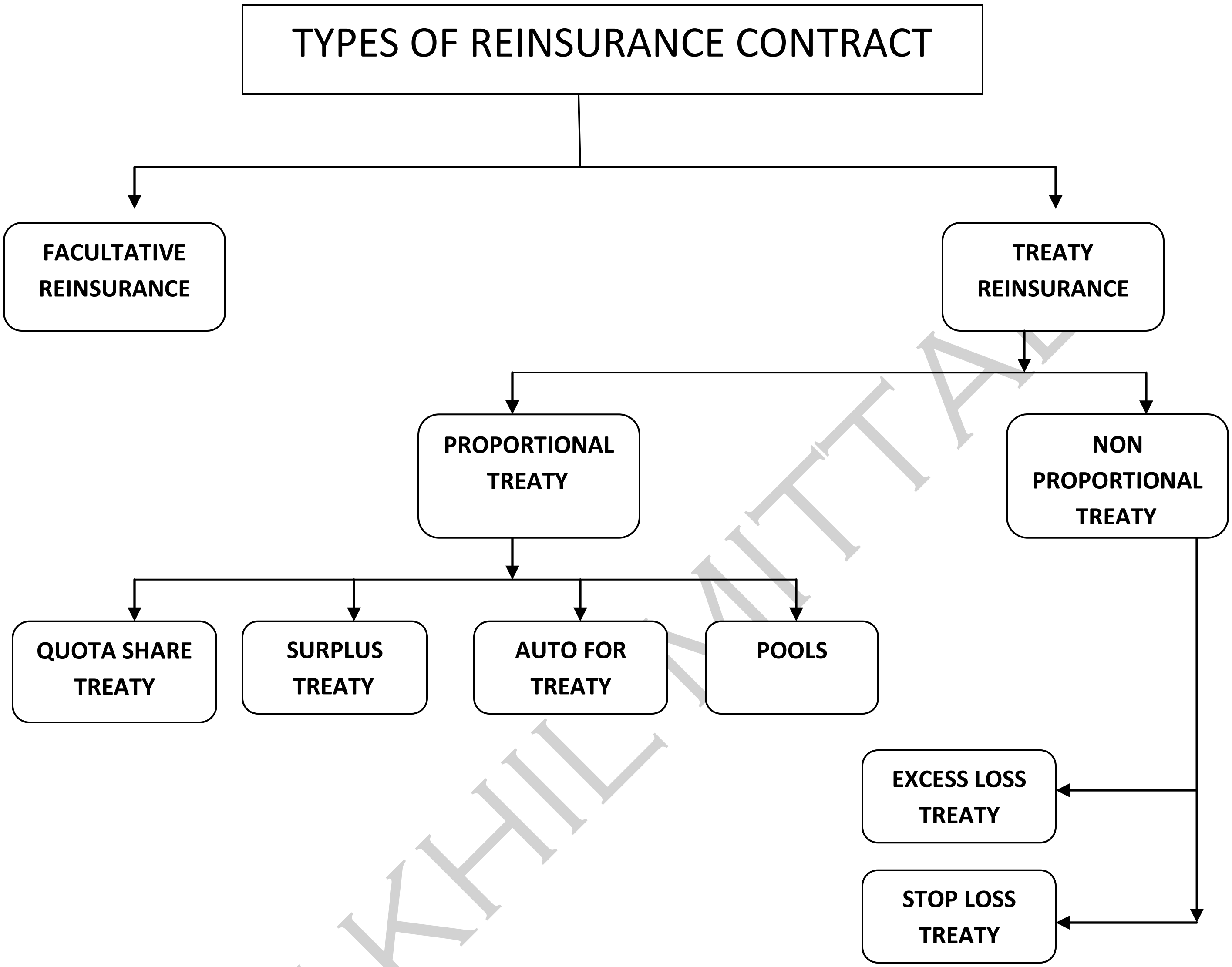
RE-INSURANCE

A Reinsurance transaction may be defined as **agreement between:**

A — **CEEDING COMPANY** INS. CO.

RE-INSURER COMPANY — **B**

■ It is original company **(A)** which has accepted the risk.	■ This company **(B)** agrees to accept a specified share of risk of policy of original insurer **(A).**
■ This company **(A)** has agreed to **"Cede-** Give**" or passes** on the risk to another insurance company.	
■ In case of claim, **original insurer (A),** is liable, but it will lodge claim with the insurer **(B).**	



Now explaining the categories in details:

1. Proportional treaty: **This treaty is based on pro-rata allotment of the sum Insured, premium or losses on a pre determined ratio.**

Under this type of treaty, there are generally 4 types of insurance:

a. **Q**uota share treaty :

- **Under this treaty, ceding company** agrees to cede a **fix % on all policies issued by it.**

b. **S**urplus Treaty:

- **Under this treaty,** ceding company identifies **excess liability** under insurance cover and **obtains reinsurance.** (*Way to remember is that surplus means excess, & in this case it is liability).*

c. **A**uto for Treaty:

- **Under this treaty,** ceding company may **reinsure** up to a defined limit after cession (**giving up**) of its surplus treaties.

d. **P**ools:

- **Under this treaty,** more than 1 insurer form a **pool** under an agreement, whereby its member cede (give up) a **pre determined** proportion of a particular category of business directly written by them, into the pool.

2.Non Proportional treaty: **This treaty is characterized by sharing of liabilities between ceding company & re-insurer on basis** of the **loss rather than** sum insured.

Under this type of treaty, there are generally 2 types of insurance:

a. **E**xcess Loss treaty :

- **Under this treaty, liability of insurer arise:**

CLAIM > predetermined amount specified for branches/entire business of ceding company.

b. **S**top Loss Treaty:

- **Under this treaty,** ceding company is covered from loosing more than specified amount for a specified class of business.

Now explaining the audit procedure in respect of reinsurance:

A. <u>VERIFICATION OF RE-INSURANCE INWARDS</u>:
(I am accepting business from insurer)

CODE TO REMEMBER: **I. - B.O.A.T.**

1. **<u>I</u>**nternal Control:
   - Auditor must **satisfy himself** with the systems of control **over the reinsurance** inward program.

2. **<u>B</u>**alance Confirmation:
   - Closing balance of **reinsurer's accounts** should be reconciled & confirmation should be obtained from them.

3. **<u>O</u>**utstanding Claims:
   - Auditor must verify that O/s claims figures are properly recorded.
   - Adequate provisions are made for the o/s claims.

4. **<u>A</u>**ccounting policies:
   - Auditor should examine **accounting policy** of the company.
   - In respect of **reinsurance** PREMIUM RECEIVED, CLAIM COST, COMMISSION.

5. **<u>T</u>**ransactions verification:
   - Auditor should verify **reinsurance inward transactions** are as per arrangement.

B. <u>VERIFICATION OF RE-INSURANCE OUTWARDS</u>:
(I am giving business to some other insurer)

CODE TO REMEMBER: B.F. - C^{2}·A^{2}.

1. **B**alance sheet:

Auditor must evaluate that if there any subsequent major events after balance sheet date, which has wider impact in reference to **outstanding claims, claims paid.**

2. **F**oreign Transactions:

Auditor must evaluate that whether the outward remittance to **foreign re-insurer** has been made as per foreign exchange regulations.

3. **C**ommission on cession:

Whether the commission on cession has been calculated as per agreement with the insurer.

4. **A**ccount scrutiny:

Auditor must evaluate each and every account so as to ensure that whether any balance requires provisioning or not.

5. **C**ession of business:

Auditor must evaluate that cession of business has been done as per stipulations **(conditions)** applicable to various categories of risks.

6. **A**ccounting aspect:

Auditor must evaluate that accounting aspect of reinsurance **cession premium, commission receivable, paid claims recovered etc.**

CO-INSURANCE

Where INSURER chooses to have more than **1 insurer** for the same transaction of risk.

PREDETERMIND SET OF UNDERSTANDING, + LEADER OF THE BUSINESS +

ISSUE POLICY WITH **COINSURANCE CLAUSE IN POLICY**

<u>Under this policy</u>:

1. Leader of the business **receives the premium.**

2. Leader of the business **also settle the claims.**

3. Balance of the **premium & claims** are accounted under co-insurance as **"AMOUNT DUE TO /FROM"** other insurance company.

4. Any difference in balances is settled in periodic meetings as agreed between the companies.