

## 12. Audit of general insurance companies

### Important Point of this chapter

1.

### Specific Control procedures related to General Insurance Business

#### 1. Underwriting

- The underwriting function, which comprise of examination and evaluation of application for insurance, the rating of risks and the establishments of premiums, is fundamental to the operation of a general insurance company. The prime objectives of an internal control system for underwriting are adherence to guidelines for acceptance of insurance, proper recording of insurance risk and its evaluation.

#### 2. Premium

- Premium is the consideration received by an insurer from he insured under and insurance contract, whereby the insurer agrees to undertake certain sum of risk on behalf of the insured.
- The objectives of internal controls over premium is to ensure that correct premium is calculated and collected before acceptance of any risk, that premium is accounted for in an appropriate manner and that the premium is collected only in respect of such risks which are assumed by the company.

#### 3. Commission

- The commission is the consideration payable for getting the insurance business. The term 'commission' is used for the payment of consideration to get Direct business.
- In case of reinsurance, the term used is 'commission on reinsurance accepted'.
- The internal control with regard to commission is aimed at ensuring that commission is paid in accordance with the rules and regulation of the company and in accordance with the agreement with the agent, commission is paid to the agent who brought the business and the legal compliances, for example, tax deduction at source and provision of the insurance Act. 1938 have been complies with.

#### 4. Reinsurance

- The key control objectives generally associated with reinsurance transaction involve determination of correct amounts for reinsurance ceded, proper valuation of assets and liabilities arising out of reinsurance transaction and adherence to legal provision, regulation and reinsurance agreements.

#### 5. Claims

- A demand for repayment of policy benefit because of the occurrence of an insured event is known as 'claim'. Cost of claims to the company includes all the expenses incurred in settlement of claims. Internal controls are established over claims to ensure that only bonafide claims are paid. Costs of claims are properly records and disclosed in the financial statements.

## Audit Procedures

The important part of the business operation of general insurance companies comprises the issuance of policies for risks assumed and to identify the insured for losses to the extent covered by such policies. So both premiums and claims have a significant impact on the insurance companies' revenue, it would be an important part of the duty of the auditor to satisfy himself that the financial transactions involving both these operations have been fairly and properly recorded in the relevant books of account.

### 1. Premium

- The premium collections are credited to a separate bank account and no withdrawals are normally permitted from that account for meeting general expenditure. As per the policy of the insurance company, the collections are transferred to the regional office or Head office. As soon as the insurance policy is issued, an entry is made in the register of the policies showing all relevant details
- Verification of premiums
  - a. 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.
  - b. The auditor should ascertain that all the cover notes relating to the risks assumed have been serially numbered for each class of business.
  - c. 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.
  - d. The auditor should verify that policy documents have not been issued, or where issued, the company was not in risk, in case
    - i. Premium had not been collected at all;
    - ii. Premium had been collected but relevant cheques have been dishonored;
    - iii. Premium had not immediately been collected due to furnishing of a bank guarantee or cash deposit but either deposit or guarantee had fallen short or has expired or the premium had been collected beyond the stipulated time limit.
    - iv. Where premium has been accrued but has not been received; and
    - v. Installments of premium have not been collected in time in respect of certain categories of policies.
  - e. 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:
    - i. Deposit premium account
    - ii. Premium received in advance account
    - iii. Inspector's Deposit Accounts
    - iv. Agent's Premium Accounts
  - f. In case of co-insurance business if the audited company is not leader then see that the company's share of the premium is accounted. And in case of 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 premium collected.

- g. The auditor should check whether premium registers have been maintained chronologically, for each underwriting department, giving full particulars including service tax charges as per acceptance advice on a day-to-day basis.
- h. Where policies have been issued with a provision to collect premium periodically.
- i. The auditor should verify whether installments have falling due on or before the balance sheet date, whether received or not, have been accounted for as premium as for the year under audit.
- j. The auditor should verify the year and transaction to check that amounts received during the year in respect of risks commencing/installments 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.
- k. 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.
- l. 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.
- m. Where premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered.

## 2. Claims

- Claims under policies comprise the claims paid for losses incurred, and those estimated or anticipated claims pending settlements under the policies. Settlement cost of claims includes surveyor fees, legal expenses etc. a liability for outstanding claims should be brought in account on the following:
  - i. Direct Business
  - ii. Inward Reinsurance business; and
  - iii. Co-insurance Business
- Verification of Claims: there are two type of procedure which are as follows
  - i. Claims Provision
    - The auditor should obtain form the branches, the information for each class of business, categorizing the claims value-wise before commencing verification of the claims provision, so that appropriate statistical sampling techniques may be applied, to ensure that representative volumes of claims is verified for each class of business.
    - the auditor should satisfy himself that the estimated liability of provided for by the management is adequate with reference to the relevant claim files/docket, keeping in view the following:
      - a. That the provision has been made for all unsettled claims as at the year-end on the basis of claims lodged/communicated by the parties against the company. The date of loss is important for recognizing the claim as attributable to a particular year.
      - b. That provision has been made for only such claims for which the company is legally liable, considering particularly, (a) that the risk was covered by the policy, if in force and the claims arose during the currency of the policy; and (b) that claim did not arise during the period the company was not supposed to cover the risk.

- c. That the provision made is normally in excess of the amount insured except in some categories of claims matters may be sub-judice in legal proceedings which will determine the quantum of claim.
- d. That the determining the amount of provision, event after the balance sheet date has been considered.
- e. That the claims status report recommended to be prepared by the divisional manager on large claims outstanding at the year-end have been reviewed with the contents of relevant file or dockets for determining excess/short provision.
- f. Whenever an unduly long time has elapsed after the filing of the claim and there has been no further communication and no litigation or arbitration dispute is involved, the reasons for carrying the provision has been ascertained.
- g. Whenever legal advice has been sought or the claim is under litigation, the provisions is made according to the legal advisor's view and differences, if any, are explained.
- h. That in case of amounts purely in the nature of deposits with courts or other authorities, adequate provision is made and deposits stated separately as assets and provision are not made net of such deposits.
- i. Intimation of loss is received within a reasonable time and reasons for undue delay intimation are looked into.
- j. That due provision has been made in respect of claims lodged at any office of the company other than one from where the policy was taken.

## **ii. Claims Paid**

- a. In case of co-insurance arrangements, claims have been booked only in respect of company's share and the balance has been debited to other insurance companies
- b. In case of claims paid on the basis of advice form other insurance companies, whether share of premium has also recovered by the company. Such claims which have been communicated after the year-end for losses which occurred prior to the year end must be accounted for in the year of audit.
- c. Claims payment have been duly sanctioned by the authority convened and the payments of the amounts are duly acknowledged by the claimants;
- d. 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 procedures.
- e. The amounts of the nature if pure advances/ deposits with courts etc., in matters under litigation have not been treated as claim paid but are held as assets till final disposal of such claims.
- f. Payment made against claims partially settled has been duly vouched.
- g. In case of final settlement of claims, the clamant has given an unqualified discharge note, not involving the company in any further liability in respect of the claim; and
- h. The figures of claims, wherever communicated for the year by the division to the Head office for purpose of reinsurance claims, have been reconciled with the trial balance figure.

### **iii. Commission**

- Verification of commission are as follows
  - a. Vouch disbursement entry with reference to the disbursement vouchers with copies of commission bills and commission statements
  - b. Check whether the vouchers are authorized by the officers-in-charge as per rules in force and income tax is deducted at source, as applicable.
  - c. Test check correctness of amounts of commission allowed.
  - d. Scrutinize agent's ledger and the balances, examine account having debit balance, if any, and obtain information on the same.
  - e. Check whether commission outgo for the period under audit been duly accounted.

### **iv. Operating expenses related to Insurance business**

- All the administrative expenses in an insurance business are broadly classified under 13 heads as mentioned in schedule 4. And any other expense is disclosed in 'other' head.
- 'Other' would include foreign exchange gains or losses as indicated in note 'B' of Schedule 4. Any major expenses (Rs. 5 lacs or in excess of 1% of the net premium, whichever is higher) are required to be shown separately.

#### **v. Other expenses which are audited as per normal procedure. Such expenses are**

- Legal and professional charges
- Employees' remuneration and welfare benefits
- Interest and Bank charges
- Depreciation

### **vi. Interest, Dividend and Rent**

- The interest or dividend earned as against the policyholders' fund is required to be apportioned to revenue account.
- The interest earned on, say, grant of vehicle loans, housing loans, deposits with banks of the shareholders, funds, rent received on let out properties owned by the company, by way of investment shareholders, funds etc. are required to be shown under profit and loss account.

## **Audit of items relating to Balance sheet**

### **1. Investments**

- Sub section (4) of 27B requires that an insurer should not invest or keep invested any part of its assets in the shares of any one insurance company or an investment company which constitute more than 10% of the total assets of the insurer or two percent of the subscribed share capital or debentures of the insurance companies or investment company concerned.
- It may be noted that in case of any investment has been made in the partly paid up shares of a company, the uncalled liability on the shares is to be added to the amount invested for the purpose of computing the percentage referred to above.
- Section 27C of the Insurance Act, prohibits an insurer from investing, directly or indirectly, funds of the policy-holders outside India. It implies that the fund which does not belong to policyholders can be invested outside India. i.e. Share capital, Loans raised, Balance lying in Free reserves.

- Regulation 4 of the amended regulation on investment prescribes that every insurer carrying on the business of general insurance should invest and at all times keep its total assets in the following manner

|            |                                                                                                    |                                                              |
|------------|----------------------------------------------------------------------------------------------------|--------------------------------------------------------------|
| <b>I</b>   | Government Securities                                                                              | Not less than 20% of investment assets                       |
| <b>II</b>  | Government Securities and other approved securities                                                | Not less than 30% of investment assets (including (i) above) |
| <b>III</b> | Approved investments and other investments (other investments not exceed 25% of investment assets) | Not exceeding 55%                                            |
|            | Housing and loans to state government                                                              | Not less than 5%                                             |
|            | Investment in infrastructure                                                                       | Not less than 10                                             |

## 2. Cash and Bank Balances

- in same manner as applied in other company

## 3. Outstanding Premiums and Agent's Balances

- Scrutinize and review control account debit balances and their nature should be enquiries into.
- Examine inoperative balances and treatment given for old balances with reference to company rules
- Enquire into the reasons for retaining the old balances
- Verify old debit balances which may require provision or adjustments. Notes of explanation may be obtained from the management in this regard.
- Check age-wise, sector-wise analysis of outstanding premium.
- Verify whether outstanding premium since have been collected.
- Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

## 4. Provision for Taxation

- Check whether tax provision mad after considering specific provision applicable to insurance business
- It should be seen by auditor whether for the purpose of computation not only the profit as disclosed by the annual accounts, copies of which are required under the insurance act to be furnished to the controller of insurance is taken but also the accounts furnished by the company to the controller of insurance account.
- the compliance with the provision of Chapter III the income tax act, 1961 which provides for income which do not form part of total income as also to be seen.
- The auditor should see whether deduction under chapter VI A of the income tax Act, 1961 which provides for deduction have been made in computing total income is properly taken into account.
- The auditor should examine whether income computation relating to foreign branches and other income earned outside India is dealt with properly as per the DTAA, if any entered into with those countries.
- Also, the auditor should check whether the grossing up of TDS relating to the income has been properly done for the purpose of computation of taxable income.

- The auditor may also assess the applicability of the wealth Tax Act, 1957 with reference to the assets of the Company at the end of the year.
- the auditor should see the system of service tax collection and the payment o the statutory authorities have and the respective states ad the past trend in this regard.
- The auditor should check the liability under the VAT and whether provision for adequate amount has been made in books or not.

## 5. Unexpired risk reserve

- The need for unexpired risk reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurance close their accounts on a particular date, not all risks under policies expire on that date. Many policies normally extend beyond this date into the following year during which risk continues.
- The effort involved in calculation unexpired portion of premium under each policy is very time consuming thereof, a simple formulae to derive percentage of premium income to be allocated for reserve for unexpired risk is adopted.
- According to the requirement of insurance act for the purpose of maintain solvency margin, it is sufficing if the provision is made for unexpired risks at 50% for fire, marine cargo and miscellaneous business except for marine Hull which has to be 100%.

## Reinsurance

1. **Facultative Reinsurance:** it is the type of reinsurance whereby the contract relates to one particular risk and is expressed in the reinsurance policy. Each transaction under facultative reinsurance has to be negotiated individually. Each party to the transaction has a free choice.
2. **Treaty Reinsurance:** this type of reinsurance, a treaty agreement s entered into between the ceding company and the reinsurer where reinsurer is within the limits of the treaty. These limits can be monetary, geographical, section of business etc.
  - **Treaties can also be divided in two categories**
    - a. **Proportional treaties:** such treaties are based on pro-rata apportionment of the sum insured, premium and losses, according to a pre-determined percentage/ratio. These treaties can further classified as below
      - I. Quota Share treaty
      - II. Surplus treaty
      - III. Auto-fac Treaty
      - IV. Pools
    - b. **Non-proportional Treaty:** Such treaties are characterized by a distribution of liability between the ceding company and the reinsurer on the basis of losses rather than the sum insured, as is the case in the proportional reinsurance. Following are characteristic of Non-proportional treaty
      - Premium is not calculated on each cession, but on the whole portfolio of the ceding company
      - The premium rate is predetermined
      - Cost of reinsurance can vary substantially each year, depending on the premium income, loss ration and reinsurance marked situation.
      - Normally no commission is paid.

- Types of Non-proportional treaties are as follows
  - I. Excess of loss treaties
  - II. Excess of loss cover on prevent basis
  - III. Excess of loss cover on non-prevent basis
  - IV. Stop loss treaties

### **Verification Procedures of re-Insurance Business Inward**

- It is necessary to ensure that the inward insurance arrangements and acceptance, both Indian and foreign are done as per the prescribed parameters applicable for the particular year.
- The auditor should check that domestic inward acceptance is in accordance with the approved programmed.
- The auditor should examine whether proper system exists to have control over the quantum of agreements existing at any point of time and also that periodical accounting statements received in connection with the agreements.
- The auditor should verify whether proper closing returns have been received for premiums and claims for facultative acceptance.
- The auditor should check the accounts for closure of any underwriting year, with portfolio withdrawals as per the terms and condition agreed.
- The auditor should evaluate the system and practice adopted in recognizing the foreign currency transaction and also whether it is accordance with the accounting standard-11 for the effects of changes in foreign rates.
- The auditor should verify whether profit commission has been calculated as per the agreement and terms and conditions and the statements rendered are properly taken into account.
- The auditor should check whether there is any run off claim/large claim of long chain in nature which requires any provisioning.
- It is essential that the statement should be rendered in the currency in which it was agreed to be transacted and the conversion of foreign currency balances from the account submitted have been done at the appropriate conversion rates as per AS-11
- Closing balance of the re-insurer's account should be reconciled and the confirmation of balance should be obtained from all the companies.
- The auditor should verify the requirement of provision/ write off of reinsurance inward balances based on the doubtful nature of recovery, if any

### **Verification of Re-Insurance Outward**

- 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.
- The auditor should check whether the pattern if re-insurance underwriting for outward cessions has fits within the parameters and guidelines applicable to the relevant year.
- The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.
- The auditor should verify whether the sessions have been made as per the agreements with the various companies.

- It should be seen whether the outward remittances to foreign re-insurance have been done as per the foreign exchange regulation.
- They should also see whether the commission on cession has been calculated as per the terms of the agreement with re-insurance.
- The auditors should verify the computation of profit commission for various automatic treaty agreements in the light of the periodical accounts rendered and in relation to outstanding loss operating to that treaty.
- The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.
- 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.
- He 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.
- He should see whether provisioning for outstanding losses recoverable on cession have been confirmed by the re-insurer and in the case of major claims, documentary support should be insisted and verified.
- Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.
- The auditor should check percentage pattern of goods to net-premium, claims paid and outstanding claims to ensure justification.
- The auditor should also check whether the re-insurance balance on cession and whether the sub ledger balances tallies with the general ledger balances.
- The auditor should review the individual accounts to find out whether any balance requires provisioning/write off or write back.
- He should verify whether the balances with reinsurers are supported by necessary confirmation obtained from them.
- He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims.
- Any major event after the balance sheet date which might have wider impact with the reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought suitably.

### **Co-insurance**

Where the insured chooses to have more than one insurer for the same transaction of risk, it would amount to coinsurance. The insurance council may recommend the following norms while entering into coinsurance agreement.

- Settlement of commission
- Collection and remittance of service tax
- Standard practices for settlement of dues
- Settlement of claims
- Reinsurance arrangement for the risk booked
- Exceptional booking and the powers thereof deviating from the council's understanding.

## **Solvency Margin**

Act 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 insurer carrying on general insurance business the solvency margin should be highest of the following amounts

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

## **Trade credit insurance**

TCI business means the business of effecting contracts of insurance in respect of trade credit insurance business

TCI means insurance of suppliers against the risk on non-payment of goods or services by their buyers who may be situated in the same country as the supplier or a buyer situated in another country against non payment as a result of insolvency of the buyer non-payment after an agreed number of months after due-date or non-pay amen following an event outside the control of the buyer or seller

Basic requirement of TCI are as follows

- a. Policyholders' loss is non-receipt of trade receivables arising out of a trade of goods or services.
- b. Policyholder is a supplier of goods or service in consideration for fair market value.
- c. Policyholder's trade receivable does not arise out of factoring or reverse factoring arrangement or any other similar arrangement.
- d. Policyholder has a customer who is liable to pay a trade receivable to the policyholder in return for the goods and service received by him from the policyholder, in accordance with a policy document filed with the insurer.
- e. Policyholder undertakes to pay premium for the entire policy period.
- f. Any other requirement that may be specified by the authority from time to time.