

Audit of General Insurance Companies

12.1 Introduction

The general insurance business in India is governed by the Insurance Act, 1938 which is based on the British Insurance Act. The Act was amended in 1969 for social control to govern the general insurance business on healthy lines. However, it was felt that there still existed some scope for improvement. In view of this, on May 13, 1971 the government nationalised the general insurance industry by an ordinance which became the General Insurance (Nationalisation) Act, 1972. At that time there were 63 domestic insurance companies and 44 foreign, insurance companies operating in India. The managements of all the 107 companies were taken over by the Government and accordingly the General Insurance Corporation (GIC) was formed as a government company on November 22, 1972. The GIC as the holding company is entrusted with the task of superintending, controlling and carrying on the general insurance business in the country. Its subsidiaries in all the four zones of the country viz., the Oriental Fire & General Insurance Company (now known as the Oriental Insurance Co. Ltd.), the National Insurance Company Ltd., the New India Assurance Company Ltd. and the United India Insurance Company write all classes of direct business of general insurance except aviation which is written by the GIC.

The liberalisation of insurance sector has changed the nature of State involvement in insurance from controlling operations to establishing and monitoring market functioning rules, prudential regulations, focussing on solvency requirements and customer protection measures. Accordingly, the Government of India, with a view to achieving effective regulation, decided to establish a regulator of the insurance industry. The decision of the Government was translated into reality by the enactment of Insurance Regulatory and Development Authority (IRDA) Act in the year 1999. The Insurance Regulatory and Development Authority Act, 1999 (Authority in brief) provided for the establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto. The Authority has been assigned the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business.

12.2 Legal Framework

It is important for the auditor to familiarise himself with various statutes governing the insurance industry. The auditor, while familiarising himself with various rules, regulations, relevant notifications, should also look into the important aspects arising out of those which might have an effect on determination of nature, timing and extent of audit procedures, while performing his role as an auditor.

The primary legislations which deal with the insurance business in India are the Insurance Act, 1938 and the IRDA Act, 1999. Various aspects relating to audit are dealt with around the framework of the following statutes and rules made thereunder:

- (a) The Insurance Act, 1938 (including Insurance Rules, 1939);
- (b) The Insurance Regulatory and Development Authority Act, 1999;
- (c) The Insurance Regulatory and Development Authority Regulations framed under the IRDA, Act, 1999;
- (d) The Companies Act, 1956; and
- (e) The General Insurance Business (Nationalisation) Act, 1972 (including Rules framed thereunder).

Some relevant statutory provisions are discussed below:

Insurer - Section 2(9) of the Insurance Act, 1938 (hereinafter referred to as the 'Act') defines the term 'Insurer' as:

- “(a) any individual or unincorporated body of individuals or body corporate incorporated under the law of any country other than India, carrying on insurance business not being a person specified in sub-clause (c) of this clause which –
- (i) carries on that business in India, or
 - (ii) has his or its principal place of business, employs a representative, or maintains a place of business, in India;
- (b) any body corporate not being a person specified in sub-clause (c) of this clause carrying on the business of insurance, which is a body corporate incorporated under any law for the time being in force in India; or stands to any such body corporate in the relation of a subsidiary company within the meaning of the Indian Companies Act, 1913, (7 of 1913), as defined by sub-section (2) of Section 2 of that Act; and
- (c) any person who in India has a standing contract with underwriters who are members of the Society of Lloyd's whereby such person is authorised within the terms of such contract to issue protection notes, cover notes, or other documents granting insurance cover to others on behalf of the underwriters,
- but does not include a principal agent, chief agent, special agent, or an insurance agent or a provident society”.

Policy Holder - Section 2(2) of the Insurance Act, 1938 defines the term policy holder as a person to whom the whole of the interest of the policy holder in the policy is assigned once and for all, but does not include an assigner thereof whose interest in the policy is defensible or is for the time being subject to any condition.

Prohibition of Insurance Business by Certain Persons - Prior to the Insurance Regulatory and Development Authority Act, 1999 coming into force, as per Section 2C of the Insurance Act, 1938, the insurance business could be transacted by a public company, a co-operative society or any body corporate. All the three kinds of organisations were permitted to engage in

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the business of any class of insurance. Third proviso to section 2C(1) of the Insurance Act, 1938 (inserted by the IRDA Act, 1999) prohibits persons other than an Indian insurance company to begin to transact the insurance business after the commencement of the Insurance Regulatory and Development Authority Act, 1999. Thus, the enterprises that were engaged in the insurance business prior to the commencement of the IRDA Act, 1999 continue to exist but a new insurance industry entrant can only be an Indian insurance company. The proviso inserted under section 2C(1) of the Act is reproduced below:

“Provided also that no insurer other than an Indian Insurance Company shall begin to carry on any class of insurance business in India under this Act on or after the commencement of the Insurance Regulatory and Development Authority Act, 1999”.

The definition of Indian Insurance Company given under section 2(7A) of the Insurance Act, 1938 is also reproduced:

“An Indian insurance company means an insurer being a company-

- (a) which is formed and registered under the Companies Act, 1956;
- (b) in which the aggregate holding of equity shares by a foreign company, either by itself or through its subsidiary companies or nominees does not exceed 26% of the paid up equity capital of such Indian insurance company; and
- (c) whose sole purpose is to carry on life insurance business or general insurance business or re-insurance business.

Explanation: For the purposes of this clause, the expression “foreign company” shall have the meaning assigned to it under Clause (23A) of section 2 of the Income-tax Act, 1961 (43 of 1961).”

The Insurance (Amendment) Act, 2002 provides as per sub-section (3) of Section 2C that an insurance cooperative society may carry on any class of insurance business in India.

Registration of Indian Insurance Companies - Section 3 of the Insurance Act, 1938 requires every insurer to obtain a certificate of registration before commencement of insurance business in India. The section empowers the Authority to make regulations for registration of insurers. It may be noted here that no insurer other than an Indian insurance company can commence the insurance business after the enactment of the IRDA Act, 1999. The registration of Indian insurance companies is done in accordance with the Insurance Regulatory and Development Authority (Registration of Indian Insurance Companies) Regulations, 2000. The salient features of these Regulations are as follows:

Licensing of Insurance Agents - Section 42 of the Insurance Act, 1938 requires that a person desirous of becoming an insurance agent for the purpose of soliciting or procuring insurance business should not suffer from any of the disqualifications mentioned in sub-section (4) of Section 42 of the Act. In order to be qualified under sub-section (4), a person desirous of becoming an insurance agent should possess the requisite qualifications and practical training for a period not exceeding 12 months, as may be specified by the regulations made by the Authority in this behalf. It may be noted that the Authority has issued IRDA (Licensing of Insurance Agents) Regulations, 2000. An insurance agent seeking renewal of his

license is also required to comply with the IRDA (Licensing of Insurance Agents) Regulations, 2000. There is also a stringent code of conduct prescribed for the insurance agents and for those seeking renewal of license, at least 50 hours of training is a prerequisite.

Obligations of Insurance Companies to the Rural and Social Sectors - Like any other industry, the insurance industry also has certain social obligations. For effective discharge of these obligations, the IRDA Act, 1999 inserted sections 32B and 32C in the Act. Section 32B empowers the Authority to prescribe the percentages of life insurance business, and general insurance business in the rural or social sector. Section 32C makes it mandatory for every insurer to discharge his obligations mentioned under section 32B of the Act. The obligations include providing life insurance and general insurance cover to the persons residing in the rural sector including insurance for crops, workers in the unorganised or informal sector or for economically vulnerable or backward classes of the society and such other categories of persons as maybe specified by the Regulations made by the Authority. In exercise of the powers conferred by section 32B and section 32C of the Act, the Authority has issued IRDA (Obligation of Insurers to Rural or Social Sectors) Regulations, 2000. According to the Regulations, during the first five financial years, an insurance company is required to ensure that the total gross premium income pertaining to the rural sector (including insurance for crops) should be atleast 2% in the first financial year, 3% in the second financial year and 5% thereafter of the total gross premium income written directly in that year.

'Rural sector' means any place as per the latest census, which has –

- (i) a population of not more than five thousand;
- (ii) a density of population of less than four hundred per square kilometer; and
- (iii) at least twenty-five per cent of the male working population is engaged in agriculture.

Power to Suspend Registration- The Authority, under section 14(2)(a) of the IRDA Act, 1999, has the power to suspend a class or classes of insurance business for such period as may be specified, after holding an inquiry in accordance with the procedures prescribed in the Regulations. Insurers have to cease to transact new insurance business of such class(es) from the date of suspension or cancellation of the Certificate.

Requirements as to the Minimum Paid-up Capital - The minimum paid-up equity share capital of an Indian insurance company carrying on general insurance business should be ₹ 100 crores or more, excluding deposits under Section 7 of the Insurance Act, 1938 and preliminary expenses incurred in the formation and registration of company. The transitional period of six months for existing insurance companies is allowed from the date of commencement of the IRDA Act, 1999 for achieving the minimum paid up capital. The management of an insurance company needs to certify the pattern of shareholding as on every Balance Sheet date.

Deposits - Section 7 of the Insurance Act, 1938 requires every insurer, carrying a general insurance business, to deposit and keep deposited with RBI in it's one of the offices in India a sum equivalent to three percent of total gross premium written in India in any financial year. The maximum limit of deposit under this section is Rupees ten crores. The deposit is to be for and on behalf of the Government of India. The deposit can be made either by way of cash or

investment in approved securities. If securities are deposited, their estimated market value on the date of deposit is to be seen. The amount of deposit required in the case of reinsurance business is rupees twenty crores. The proviso to sub-section (1) of Section 7 relaxes the deposit requirement in cases where the business done or to be done is marine insurance business or relates exclusively to country craft or its cargo or both. The amount of deposit required in such cases is Rupees one lacs only. It may be noted here that an insurer cannot be registered for any class of insurance business in addition to the class or classes for which the insurer is already registered until the full deposit required under section 7 has been made in respect of insurance business already being carried on by the insurer.

According to section 8 of the Insurance Act, 1938, the deposit made under section 7 are not susceptible of any assignment or charge and are also not available for discharge of any liability of the insurer other than those arising from the insurance policies issued and remaining undischarged. The deposit is also not liable to attachment or decree except a decree obtained by a policyholder in case of non discharge of liability arising out of the insurance policy issued. Section 9 of the Act provides for refund of deposit in case the insurance business is closed and all the liabilities have been settled. The Court, after satisfaction and an application made by insurer, may order refund.

12.3 Insurance Regulatory and Development Authority (IRDA) Act, 1999 and Regulations Framed thereunder

As mentioned earlier, the IRDA Act, 1999 has established the Insurance Regulatory and Development Authority (the Authority) and has also provided for establishment of the Insurance Advisory Committee to advise the Authority on various matters. The IRDA Act, 1999 has also made amendments to the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972 by insertion of the First, Second and Third Schedules to the IRDA Act, 1999. These Schedules contain amendments to rationalise the provisions of the Insurance Act, 1938 and other statutes with the IRDA Act, 1999 and the Regulations.

12.4 Features of Accounting System of Insurance Companies

The system of recording, classifying and summarising the transactions in insurance companies, is, in substance, no different from other entities. However, in case of insurance companies, the ledger accounts specially those of premiums, claims, commissions, etc. need to be given greater attention. The functions of accounting system in general insurance business under IT environment may be based on:

- ◆ Underwriting module
- ◆ Claims module
- ◆ Agency management module
- ◆ Accounts module
- ◆ Investment module
- ◆ Reinsurance module

Every insurer, after the commencement of the Insurance Regulatory and Development Authority Act, 1999, in respect of insurance business transacted and in respect of shareholder's funds, is required to prepare a Balance Sheet, a Profit and Loss Account, a separate Account of Receipts and Payments, a Revenue Account for each year in accordance with the Regulations made by the Authority. Sub-section 1B of section 11, of the Insurance Act, 1938, specifies that every insurer should keep separate accounts relating to funds of shareholders and policyholders.

12.4.1 Form and Contents of Financial Statements - Section 11(1A) of the Insurance Act, 1938 provides -

"Every insurer, on or after the commencement of the Insurance Regulatory and Development Authority Act, 1999, in respect of insurance business transacted by him and in respect of his shareholders' funds, shall, at the expiration of each financial year, prepare with reference to that year, a balance-sheet, a profit and loss account, a separate account of receipts and payments, a revenue account in accordance with the regulations made by the Authority."

The Authority, in pursuance of the powers conferred to it by the provisions of Section 114 A of the Insurance Act, 1938, has issued regulations for the preparation of the financial statements and auditor's report of companies carrying on insurance business. The Regulations contain three schedules. Schedule A is applicable to companies carrying on life insurance business. Schedule B of the Regulations lays down the accounting principles, disclosures forming part of financial statements, general instructions for preparation of financial statements, the contents of the management report and the formats in which the financial statements of an insurer carrying on general insurance business should be drawn up. Schedule B is in five parts, covering various aspects related to the preparation of financial statements, which form the main basis for preparation of financial statements of general insurance companies. The five parts have been outlined in the following paragraphs. Schedule C to the Regulations lays down the matters to be dealt with by the auditor's report of an insurance company. Schedule C is applicable to insurers carrying on general insurance business as well as life insurance business.

12.4.2 Requirements of Schedule B to the IRDA (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2002 –

Part I – Accounting Principles for Preparation of Financial Statements

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| 1. Applicability of Accounting Standards | 2. Premium |
| 3. Premium Deficiency | 4. Acquisition Costs |
| 6. Recognition of Surplus arising in non-participating funds as profit / loss in the Profit & Loss Account | 5. Claims |
| 7. Loans | 8. Catastrophe Reserve |

PART II: Disclosures forming part of Financial Statements

Part III: General Instructions for Preparation of Financial Statements

Part IV: Contents of Management Report

Part V: Preparation of Financial Statements

For details alongwith Format of the above, students may refer Chapter 5 of Volume I of the Paper 5 Advanced Accounting, IPCC Study Material.

Audit Considerations - As mentioned earlier, Schedule C to the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000 prescribes the matters to be dealt with by the auditor's report. The auditors, under clause (3) of Schedule C to the Regulations, are required to certify that they have reviewed the management report and there is no apparent mistake or material inconsistencies in the management report with the financial statements. The auditors are also required to certify that the insurer has complied with the terms and conditions of the registration stipulated by the Authority.

From the foregoing, it is clear that the auditor has to examine the contents of the management report with a view to certify that there are no material inconsistencies in the same with the financial statements. The auditor should, based upon the audit conducted and information and explanations gathered during the course of the audit, verify that there are no material misstatements in the management report. As far as certification of compliance with the terms and conditions of the registration stipulated by the Authority is concerned, the auditor should ask for the relevant documents from the management of the company and conduct an examination thereof. Based on his observation, the auditor should certify the aforesaid compliance.

12.4.3 Signatures and Reports to be attached with the Accounts and Statements- Sub-section (2) of section 11 of the Insurance Act, 1938 provides that the accounts and statements referred to in sub-section (1) should be signed, in the case of a company, by the chairman, if any, and two directors and the principal officer of the company. It further provides that the accounts and statements should be accompanied by a statement containing the names, descriptions and occupations of, and the directorships held by, the persons in charge of the management of the business during the period to which such statements refers, and by a report on the affairs of the business during that period.

12.4.4 Requirements of the Insurance Act, 1938 vis a vis the Companies Act, 1956 - Disclosures under the Companies Act, 1956 relating to the Balance Sheet and Profit and Loss Account of the company, in so far as they are not inconsistent with the provisions of the Insurance Act, 1938, also apply to the Balance Sheet and Profit and Loss Account of an insurance company.

Sub-section (5) of section 211 of the Companies Act, 1956 provides that the Balance Sheet and the Profit and Loss Account of a company should not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose, in the case of an insurance company, any matters which are not required to be disclosed under the Insurance Act, 1938 (4 of 1938). However, if an insurance company so desires, it may disclose the information not required to be disclosed under the Insurance Act, 1938.

According to Section 616 of the Companies Act, 1956, the provisions of the Companies Act, 1956 apply to insurance companies, except in so far as the said provisions are inconsistent with the provisions of the Insurance Act, 1938. Section 117 of Insurance Act, 1938, provides

that nothing in the Insurance Act, 1938 shall affect the liability of an insurer, being a company, to comply with the provisions of the Indian Companies Act, 1913 in matters not otherwise specifically provided for by Insurance Act, 1938. Therefore, the provisions of the Companies Act, 1956 would be applicable wherever the Insurance Act, 1938 does not cover the relevant aspects and the insurer is a company within the meaning of the Companies Act, 1956. The provisions of the Companies Act, 1956 should be applied in a harmonised manner with the provisions of the Insurance Act, 1938, and the rules and regulations framed thereunder.

It may be mentioned here that the erstwhile Indian Companies Act, 1913 has been replaced by the Companies Act, 1956. Therefore, it is suggested that reference to 1913 legislation should be construed as a reference to the corresponding provisions of the Companies Act, 1956.

12.4.5 Accounting Policies - The IRDA Regulations on preparation of financial statements and auditor's report specify that the following accounting policies should form an integral part of the financial statements:

- (a) All significant policies in terms of Accounting Standards issued by the Institute of Chartered Accountants of India, and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies followed by the insurer should be stated in the manner required under AS-1 issued by the Institute of Chartered Accountants of India.
- (b) Any departure from the accounting policies as aforesaid is required to be separately disclosed with reasons for such departure.

In connection with the matters in respect of which the auditor has to express an opinion as prescribed in Schedule C to the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000, the auditor has to report whether the financial statements are prepared in accordance with the requirements of the Insurance Act, 1938 (4 of 1938), the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999) and the Companies Act, 1956 (1 of 1956), to the extent applicable and in the manner so required.

12.5 Audit of Accounts

Under section 12 of the Insurance Act, 1938, the financial statements of every insurer are required to be audited annually by an auditor. Section 2(4) of the Insurance Act, 1938 defines the term 'auditor' as a person qualified under the Chartered Accountants Act, 1949 to act as an auditor of a company. The auditor, for audit of financial statements, has the powers to exercise the rights vested in, and discharge the duties and be subject to the liabilities and penalties imposed on auditors of companies under the Companies Act, 1956.

The provisions of Section 12 of the Insurance Act, 1938 apply only in a case where the financial statements of the insurer are not subject to audit under the Companies Act, 1956. A company carrying on general insurance business is subject to audit requirements laid down under the Companies Act, 1956.

The financial statements under section 12 include Balance Sheet, Profit and Loss Account and Revenue Account. Section 12 of the Insurance Act, 1938 does not cover the requirement for

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audit of the Receipts and Payments Account of an insurer. It may be noted that the Insurance Regulatory and Development Authority Act, 1999 inserted a new sub-section (1A) in Section 11 of the Insurance Act, 1938. The sub-section has an overriding effect over sub-section (1) of section 11 that prescribed the financial statements to be prepared by an insurer. The new sub-section requires that after the commencements of IRDA Act, 1999, 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 Payment Account is also required to be audited.

The Authority, in exercise of the powers conferred by the Insurance Act, 1938, issued the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000. These Regulations require the auditor of an insurance company to report whether the Receipts and Payments Account of the insurer is in agreement with the books of account and returns. The auditor is also required to express an opinion as to whether the Receipts and Payments Account has been prepared in accordance with the provisions of the relevant statutes and whether the Receipts and Payments Account gives a true and fair view of the receipts and payments of the insurer for the period under audit. This also implies that the auditor is required to audit the Receipts and Payments Account of the insurer.

12.5.1 Appointment of auditors - The appointment of statutory auditors in the General Insurance Corporation of India, and its subsidiaries and the divisions is made by the Comptroller and Auditor General of India, as in the case of other public sector undertakings. The appointment of auditors of the agencies abroad is made by the Board of Directors of each company.

12.5.2 Rights and duties of Branch Auditors -It is a practice that the divisional offices prepares a trial balance in a manner that it provides information required to be included in the various formats of financial statements prescribed in the Insurance Act. Each trial balance, in which are incorporated the figures relating to the branches of the divisions, is required to be audited and the report thereon is furnished to the statutory auditors. The divisions of the companies carrying on general insurance business are treated for the purposes of the Companies Act, 1956 as their branches. It follows that the branch auditors appointed to conduct the audit of the divisions have the same rights and obligations under the statute as those of the, statutory auditors to whom they are expected to submit their report.

12.5.3 Auditors' Report - The Authority has prescribed the matters to be dealt with by the Auditors' Report vide Regulation 3 under Schedule C of IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000. The Schedule C is reproduced below -

"The report of the auditors on the financial statements of every insurer shall deal with the specified herein -

1.
 - (a) That they have obtained all the information and explanations which, to the best of their knowledge and belief, were necessary for the purposes of their audit and whether they have found them satisfactory;
 - (b) Whether proper books of account have been maintained by the insurer so far as appears from an examination of those books;
 - (c) Whether proper returns, audited or unaudited, from branches and other offices have been received and whether they were adequate for the purpose of their audit;
 - (d) Whether the Balance Sheet, Revenue Accounts and Profit and Loss Account dealt with by the report and the Receipts and Payments Account are in agreement with the books of account and returns;
 - (e) Whether the actuarial valuation of liabilities is duly certified by the appointed actuary, including to the effect that the assumptions for such valuation are in accordance with the guidelines and norms, if any, issued by the authority and/or the Actuarial Society of India in concurrence with the Authority.
2. The auditors shall express their opinion on:
 - (a)
 - (i) Whether the Balance Sheet gives a true and fair view of the insurer's affairs as at the end of the financial year/period;
 - (ii) Whether the Revenue Account gives a true and fair view of the surplus or the deficit for the financial year/period;
 - (iii) Whether the Profit and Loss Account gives a true and fair view of the profit or loss for the financial year/period;
 - (iv) Whether the Receipts and Payments Account gives a true and fair view of the receipts and payments for the financial year/period;
 - (b) The financial statements stated at (a) above are prepared in accordance with the requirements of the Insurance Act, 1938 (4 of 1938), the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999) and the Companies Act, 1956 (1 of 1956), to the extent applicable and in the manner so required.
 - (c) Investments have been valued in accordance with the provisions of the Act and the Regulations.
 - (d) The accounting policies selected by the insurer are appropriate and are in compliance with the applicable Accounting Standards and with the accounting principles, as prescribed in these Regulations or any order or direction issued by the Authority in this behalf.
3. The auditors shall further certify that:
 - (a) they have reviewed the management report and that there is no apparent mistake or material inconsistencies with the financial statements; and
 - (b) the insurer has complied with the terms and conditions of the registration stipulated by the Authority.

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4. A certificate signed by the auditors (which is in addition to any other certificate or report which is required by law to be given with respect to the balance sheet) certifying that :
 - (a) they have verified the cash balances and the securities relating to the insurer's loans, reversions and life interests (in the case of life insurers) and investments;
 - (b) the extent, if any, to which they have verified the investments and transactions relating to any trusts undertaken by the insurer as trustee; and
 - (c) no part of the assets of the policyholders' funds has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 (4 of 1938) relating to the application and investments of the policyholders' funds."

Students may also note that auditors are required to follow the format of report prescribed by the Institute.

12.5.4 Direction of C & AG- The Comptroller and Auditor General of India has the power to direct the manner in which the accounts shall be audited and give such instructions in regard to any matter relating to performance of functions by the auditor and to conduct the supplementary or test audit of the accounts of such companies by such person or persons as may be authorised in this behalf. For the purposes of such audit the C & AG may require information or additional information on such matters and in such form as may be directed by him in terms of Section 619 (4) of the Companies Act, 1956. The statutory auditors are required to submit a copy of their report to the C & AG who has the right to comment upon or supplement the audit report. By virtue of the powers vested in him under Section 619(3) (a) of the Companies Act, 1956 the C & AG has recently directed that a supplementary report be made by the auditors appointed under Section 619 (2) of the said Act in case of companies carrying on general insurance business. The said report would be on matters listed in the Appendix to this unit of the study.

12.5.5 Tax Audit - It is necessary for general insurance companies to get their accounts audited under Section 44AB of the said Act. For this purpose, the tax auditor(s) may be appointed by the company itself by means of a resolution of the Board of Directors or by the Chairman/Managing Director if so authorised in this behalf. The company is expected to fix separate remuneration for the auditor (s) appointed for this purpose. The Form of tax audit report applicable would be Form 3C and the prescribed particulars would have to be given in Form 3CD, in accordance with Rule 6G of the Income Tax Rules, 1962, pursuant to Section 44AB of the Income Tax Act, 1961. It is recommended that, wherever applicable, a common audit programme be framed for statutory audit and for certification of the prescribed particulars under the aforesaid rules for tax audit.

12.5.6 Applicability of CARO, 2003 - As per Section 1(2) of Companies (Auditor's Report) Order, 2003, (as amended in November 2004) the provisions of CARO are not applicable to insurance companies.

12.6 Specific Control Procedures Related to General Insurance Business

The internal control functions have been categorised below under main operational cycles considering the nature of general insurance business. Areas where the internal controls are similar to the ones adopted by other companies such as for cash and bank receipts and payments and fixed assets, have been dealt in the Internal Control Questionnaire, published by the Institute of Chartered Accountants of India. Since various operational cycles are inter-linked, the internal controls operating within the systems of such cycles should be reviewed simultaneously.

12.6.1 Underwriting - The underwriting function, which comprises of examination and evaluation of applications for insurance, the rating of risks and the establishment of premiums, is fundamental to the operations of a general insurance company. The prime objectives of an internal control system for underwriting is adherence to guidelines for acceptances of insurance, proper recording of insurance risk and its evaluation

12.6.2 Premium - Premium is the consideration received by an insurer from the insured under an 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.

12.6.3 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 regulations 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 sources and provisions of the Insurance Act, 1938 have been complied with.

12.6.4 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 transactions and adherence to legal provisions, regulations and reinsurance agreements.

12.6.5 Claims -A demand for payment 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. Cost of claims are properly recorded and disclosed in the financial statements.

12.7 Audit Procedures

The important part of the business operations of general insurance companies comprises the issuance of policies for risks assumed and to indemnify the insured for losses to the extent covered by such policies. In financial terms, these operations get translated into the receipt

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and recording of premiums and the recording and settlement of claims. Both premiums and claims have a significant impact on the insurance companies' revenues, 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. The auditor should also ensure that the legal requirements as to the disclosure of these items are complied with in the financial statements.

12.7.1 Premium - Insurance premium is collected upon issuing policies. It is the consideration for bearing the risk by the insurance company. The assumption of the risk starts on the issue of receipt based on the acceptance of proposal form or cover note by the respective underwriting department. This receipt is recorded as the premium income in the books of the insurance company. Premium may be accepted either in cash/cheque/Demand Draft/pay order, bank guarantee, cash deposit, etc. The premium collections are credited to a separate bank account and no withdrawals are normally permitted from that account for meeting the 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 Policies showing all the relevant details.

No Risk Assumption without Premium - No risk can be assumed by the insurer unless the premium is received. According to section 64VB of the Insurance Act, 1938, no insurer should assume any risk in India in respect of any insurance business on which premium is ordinarily payable in India unless and until the premium payable is received or is guaranteed to be paid by such person in such manner and within such time, as may be prescribed, or unless and until deposit of such amount, as may be prescribed, is made in advance in the prescribed manner. The premium receipt of insurance companies carrying on general insurance business normally arise out of three sources, viz., premium received from direct business, premium received from reinsurance business and the share of co-insurance premium.

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.
- ◆ 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.
- ◆ 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 discussed in this Chapter. 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; (refer Cheque Dishonoured Book);
 - (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).
- ◆ 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
 - ◆ 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.
 - ◆ 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

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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.

- ◆ 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.
- ◆ 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.
- ◆ 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.
- ◆ 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.
- ◆ 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.
- ◆ 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.
- ◆ Where premium originally received has been refunded, the auditor should verify whether the agency commission paid on such premium has been recovered.
- ◆ 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.

12.7.2 Claims -The components of the cost of claims to an insurer comprise the claims under policies and claim settlement costs. 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 fee, legal expenses, etc. A liability for outstanding claims should be brought to account on the following:

- ◆ Direct Business;
- ◆ Inward Reinsurance Business; and
- ◆ Co-Insurance business

The liability includes future payments in relation to unpaid reported claims and claims incurred but not reported including inadequate reserves which would result in future cash or asset outgo for settling liabilities against those claims. Change in estimated liability represents the difference between the estimated liabilities for outstanding claims in respect of claims under policies, whether due or intimated at the beginning and at the end of the financial period. The accounting estimate also includes claims cost adjusted for salvage value if there is sufficient degree of certainty of its realisation.

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

Registers and Records - The following register and records are generally prepared in respect of claims:

- ◆ Claims Intimation Register;
- ◆ Claims Paid Register;
- ◆ Claims Disbursement Bank Book;
- ◆ Claims Dockets, normally containing the following records:
 - ◆ Claim intimation, claim form, particulars of policy, survey report, Photograph showing damage, repairer's bills, letter of subrogation, police report, fire service report, claim settlement note, claim satisfaction note, salvage report, salvage disposal note, claims discharge voucher, etc.;
- ◆ Report of quality assurance team; and
- ◆ Salvage register

The Claim Account is debited with all the payments including repair charges, fire fighting expenses, police report fees, survey fees, amount decreed by the Courts, travel expenses, photograph charges, etc. The provision for claims incurred but not reported is not made at Branch/Divisional Office level but at the Head Office level.

Verification of Claims

Claims Provisions - The auditor should obtain from the divisions/branches, the information for each class of business, categorizing the claims value-wise before commencing verification of the claims provisions, so that appropriate statistical sampling techniques may be applied, to

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ensure that representative volume of claims is verified for each class of business. The auditor should determine the total number of documents to be checked giving due importance to claim provisions of higher value.

The outstanding liability at the year-end is determined at the divisions/branches where the liability originates for outstanding claims. Thereafter, based on the total consolidated figure for all the divisions/branches, the Head Office considers a further provision in respect of outstanding claims. The auditor should satisfy himself that the estimated liability provided for by the management is adequate with reference to the relevant claim files/dockets, keeping in view the following:

- (i) that 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 (and not the date of communication thereof) is important for recording/ recognizing the claim as attributable to a particular year. In certain circumstances, the claims are incurred by the insurance company but are not reported at the balance sheet date by the insured. Such claims are known as claims incurred but not reported (IBNR). The auditor should check the records for subsequent periods to ascertain that adequate provision has been created for such claims also.
- (ii) 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, e.g., where the premium was not paid or where cheques covering premium have been dishonoured (refer section 64 VB of the Insurance Act, 1938) or where a total loss under a policy has already been met/settled.
- (iii) that the provision made is normally not in excess of the amount insured except in some categories of claims where matters may be sub-judice in legal proceedings which will determine the quantum of claim, the amount of provision should also include survey fee and other direct expenses.
- (iv) that in determining the amount of provision, events after the balance sheet date have been considered, e.g., (a) claims settled for a materially higher/lower amount in the post-audit period; (b) claims paid by other insurance companies during the year under audit and communicated to company after the balance sheet date where other companies are the leaders in co-insurance arrangements; and (c) further reports by surveyors or assessors.
- (v) that the claims status reports recommended to be prepared by the Divisional Manager on large claims outstanding at the year-end have been reviewed with the contents of relevant files or dockets for determining excess/short provisions. The said report should be complete as to material facts to enable the auditor to take a fair view of the provision made.
- (vi) that in determining the amount of provision, the 'average clause' has been applied in case of under-insurance by parties.

- (vii) that the provision made is net of payments made 'on account' to the parties wherever such payments have been booked to claims.
- (viii) that in case of co-insurance arrangements, the company has made provisions only in respect of its own share of anticipated liability.
- (ix) that wherever 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 have been ascertained.
- (x) that wherever 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.
- (xi) that in the case of amounts purely in the nature of deposits with courts or other authorities, adequate provision is made and deposits are stated separately as assets and provisions are not made net of such deposits.
- (xii) that no contingent liability is carried in respect of any claim intimated in respect of policies issued.
- (xiii) that the claims are provided for net of estimated salvage, wherever applicable.
- (xiv) that intimation of loss is received within a reasonable time and reasons for undue delay in intimation are looked into.
- (xv) that provisions have been retained as at the year end in respect of guarantees given by company to various Courts for claims under litigation.
- (xvi) that due provision has been made in respect of claims lodged at any office of the company other than the one from where the policy was taken, e.g., a vehicle insured at Mumbai having met with an accident at Chennai necessitating claim intimation at one of the offices of the company at Chennai.

In cases of material differences in the liability estimated by the management and that which ought to be provided in the opinion of the auditor, the same must be brought out in the auditor's report after obtaining further information or explanation from the management. For determining the adequacy of the provisions in respect of any category of business, the auditor may resort to the method of testing the actual payments, wherever made, with the provisions made earlier for that category of business. Whether such liability has been estimated in the past on a fair and realistic basis can, thus, be examined by looking into current year's payments against provisions of the earlier year.

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.

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- (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 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.

12.7.3 Commission - It is a well-known fact that insurance business is solicited by insurance agents. The remuneration of an agent is paid by way of commission which is calculated by applying a percentage to the premium collected by him. Commission is payable to the agents for the business procured through them and is debited to Commission on Direct Business Account. There is a separate head for commission on reinsurance accepted which usually arise in case of Head Office. It may be noted that under section 40 of Insurance Act, 1938, no commission can be paid to a person who is not an agent of the insurance company.

The auditor should, *inter alia*, do the following for verification of commission:

- ◆ Vouch disbursement entries with reference to the disbursement vouchers with copies of commission bills and commission statements.
- ◆ Check whether the vouchers are authorised by the officers- in –charge as per rules in force and income tax is deducted at source, as applicable.
- ◆ Test check correctness of amounts of commission allowed.
- ◆ Scrutinise agents' ledger and the balances, examine accounts having debit balances, if any, and obtain information on the same. Necessary rectification of accounts and other remedial actions have to be considered.
- ◆ Check whether commission outgo for the period under audit been duly accounted.

12.7.4 Operating Expenses Related to Insurance Business (Expenses of Management) -

All the administrative expenses in an insurance company are broadly classified under 13 heads as mentioned in Schedule 4. In so far as financial statements are concerned, this Schedule is part of the Revenue Account to be prepared for insurance business. Any other expenses are required to be disclosed under the head 'Others'. 'Others' would include foreign exchange gains or losses as indicated in note 'B' of Schedule 4. Any major expenses (₹ 5 lacs or in excess of 1% of net premium, whichever is higher) are required to be shown separately. Careful reading of the words 'expenses related to insurance business' clearly indicate any expenses which do not have any direct relation to insurance business are to be shown separately in the Profit and Loss Account. Expenses relating to investment department, brokerage, bank charges, transfer fees, etc. do not have a direct relationship to the day-to-day working of the insurance business and as such would not be included in the revenue account.

These expenses are first aggregated and then apportioned to the Revenue Account of each class of business on a reasonable and equitable basis. The accounting policy should clearly indicate the basis of apportionment of these expenses to the respective Revenue Accounts (i.e., fire, marine and miscellaneous) along with the certificate that all expenses of management, wherever incurred, directly or indirectly, read with the accounting policy, have been fully debited to the respective Revenue Account as expenses. Refer to Schedule 4 on Operating Expenses for specific items.

12.7.5 Legal and Professional Charges - As far as legal and professional charges are concerned, attention is drawn to the head 'Claims Incurred' under Schedule 2 where it is clearly stated that survey fees, legal and other expenses should form part of claim cost, and therefore, are not to be included under the head Legal and Professional Charges. Hence, all other expenses which are not covered under the claims cost are required to be included under this head.

12.7.6 Employees' Remuneration and Welfare Benefits -The employees' remuneration includes all kinds of payments made to employees in consideration of their services. The reimbursement of medical expenses or premium in respect of employees' health cover is covered under the employees' remuneration and welfare. Any medical fees incurred towards maintenance of health care policies (which are not for employees) are required to be debited to the claims cost under the health care and not to be included under this head. Any expenses towards medical treatment of employees incurred by the company should also be included under this head. Non training expenses have to be shown separately.

12.7.7 Interest and Bank charges - All expenses incurred towards maintenance of Bank Account, interest and other charges levied by bankers to the normal course of business other than bank expenses relating to investments (interest, bank charges, custodial charges, etc.) are shown under the head, "Interest and Bank Charges". Any other interest charged on the borrowings which could not form part of the Revenue Account not to be included under this head.

12.7.8 Depreciation -The rates of depreciation are governed by the provisions of the Companies Act, 1956. Attention of the students is also invited to Accounting Standard (AS) 6,

Depreciation Accounting, and Guidance Note on, Depreciation in Companies, issued by the Institute of Chartered Accountants of India.

12.7.9 Interest, Dividend and Rent -An insurance enterprise, like any other, earns interest dividend and rent through its assets. The interest, dividend and rent earned are to be apportioned between Revenue Account and Profit and Loss Account. The Regulations require that basis of allocation of interest, dividend and rent between the Revenue Account and Profit and Loss Account should be clearly indicated in the company's accounting policy. The interest or dividend earned as against the policyholders' funds is required to be apportioned to the 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 investments shareholders, funds, etc. are required to be shown under the profit and Loss Account.

12.8 Items Relating to Balance Sheet

Following are the broad classes of items in a balance sheet.

12.8.1 Investments - The legal requirements for investments by enterprises carrying on general insurance business are provided under sections 27B, 27C and 27D of the Insurance Act, 1938. Sub-section (1) of section 27B lays down that no insurer carrying on general insurance business can invest or keep invested any part of its assets otherwise than in any of the approved investments mentioned in the section. Sub-section (3), however, gives a leverage to an insurer to invest or keep invested any part of its assets otherwise than in an approved investment if the following conditions are satisfied:

- (a) such investments should not exceed 25% of the total investments; and
- (b) such investments are made with the consent of all the Directors.

The consent of Directors appointed under section 34C of the Insurance Act, 1938 is not necessary. However, such Directors should not object to the investments so made or continued.

Sub-section (4) of section 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 constitutes more than ten percent 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. Similar considerations also apply to the investment in shares or debentures of any other company not being an insurance companies or investment company. In such cases, the limit of two percent of the subscribed share capital or debentures of the insurance companying company or the investment company concerned is to be read as ten percent {sub-section (5)}. According to sub-section (6), an insurer cannot invest in the shares or debentures of a private company. It may be noted that in case an 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 percentages referred to above.

Section 27C of the Insurance Act, 1938 prohibits an insurer from investing, directly or indirectly, funds of the policy-holders outside India. It implies that the funds which do not

belong to policy-holders can be invested outside India. Examples of such funds that do not belong to the policyholders are the share capital, amount of loans raised, balances lying in free reserves, etc.

The Authority has been authorized to frame regulations related to investments to be made by an insurer. The Authority has been empowered to specify, through the regulations made by it, the time, manner and other conditions of investments of assets held by an insurer. The Authority has also been granted the power of framing specific directions with regard to time, manner and other conditions subject to which the funds of policy-holders are to be invested in the infrastructure and social sector. The Authority also has the power to issue instructions to a single insurer, after taking into account the nature of business and the interests of the policy holders, the manner and other conditions of investment of assets to be held, provided the insurer is given a due opportunity of being heard before directions are issued by the Authority (Section 27D).

In exercise of the power conferred by the Insurance Act, 1938, the Authority, in consultation with the Insurance Advisory Committee, has made the Insurance Regulatory and Development Authority (Investment) Regulations are subject to revision by the Authority from time to time. Regulation 4 of the amended Regulations on investments prescribes that every insurer carrying on the business of general insurance should invest and at all times keep invested its total assets in the following manner:

(i)	<i>Government Securities</i>	<i>Not less than 20% of Investment Assets</i>
(ii)	<i>Government Securities and other approved securities</i>	<i>Not less than 30% of Investment Assets (including (i) above)</i>
(iii)	<i>(a) Approved investments and other investments (out of (iia) other investments shall not exceed 25% of Investment Assets)</i>	<i>Not exceeding 55%</i>
	<i>(b) Housing and Loans to State Government</i>	<i>Not less than 5%</i>
	<i>(c) Investment in infrastructure</i>	<i>Not less than 10%</i>

It may be mentioned here that with regard to (iv) above, subscription/purchase of bonds or debentures issued by HUDCO, National Housing Insurance Company or House Building Institutions duly accredited by National Housing Banks, for house building activities, duly guaranteed by Government or carrying current rating of not less than 'AA' by an independent, reputed and recognized agencies also qualify to be included in the limits [under clause (iv)] above.

Audit Procedures - The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investments insofar as non-compliance may have a direct and material affect on the financial statements.

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The auditor should verify the investment scrips physically at the close of business on the date the balance sheet. In exceptional cases where physical verification of investment scrips on the balance sheet date is not possible, the auditor should carry out the physical verification on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. He should take particular care to see that only genuine investments are produced before him, and that securities held by the insurance company on behalf of others (e.g., those held as security against loans) are not shown to him as the insurance company's own investments. To ensure this, the auditor should – require that all investment scrips in the possession of the insurance company – whether belonging to it or to borrowers should be produced before him simultaneously. The auditor should keep them under his control until he completes his checking. Normally, the investments of an insurance company are held by the insurance company itself or a depository (in the case of dematerialised securities other than government securities).

Investments are normally dealt with at the Head Office and not at the branches. However, sometimes, for realisation of interest, etc. and other similar purposes, investments of an insurance company may be held at Branch Offices also. In such cases, the auditor should examine the record maintained at the Head Office to record details of investments held at other locations and request the respective branch auditors to physically verify such investments as a part of their audit. The auditor should obtain a written confirmation to this effect from the branch auditors. In case the verification has been done on a date other than the balance sheet date, a statement showing the reconciliation of the investments held at the time of physical verification with the investments held as on the balance sheet date should also be obtained from the branch auditors. The branch auditors should report whether adequate records are maintained by the branch for the securities held by it on behalf of the Head Office.

Investments should not normally be held by any other person (as laid down in the City Equitable Fire Insurance Co. case). If any investments are so held, proper enquiry should be made to ensure that there is some justification for it, e.g., shares may be held by brokers for the purpose of transfer or splitting-up, etc. Shares may also be lodged with the companies concerned for transfer etc. When investments are held by any other person on behalf of the insurance company, the auditor should obtain a certificate from him. The certificate should state the reason for holding the investment (e.g., in safe custody or as security).

In respect of scripless dealings in investments through the OTC Exchange of India, the auditor should verify the interim and other acknowledgements issued by dealers as well as the year-end confirmation certificates of the depository organisation.

The auditor should also examine whether securities lodged for transfer are received back within a reasonable period. Similarly, he should examine whether share certificates, etc. are received within a reasonable period, of the lodging of the allotment advice. In case there is an unusual delay in registration of transfers, etc., the auditor should see that adequate follow-up action has been taken. He may, in appropriate cases, also enquire from the issuers, or their registrars, about the delays. In cases where the issuer/registrar has refused to register the

transfer of securities in the name of the insurance company, the auditor should verify the validity of the title of the insurance company over such securities.

The auditor should examine whether the portfolio of the insurance company consists of any securities whose maturity dates have already expired. It is possible that income on such investments may also not have been received. In case the amount of such investments or the income accrued thereon is material, the auditor should seek an explanation from the management on this aspect. He should also consider whether any provision for loss on this account is required. Similarly, where income on any security is long overdue, the auditor should consider whether provision is required in respect of such income accrued earlier.

Investments in securities now-a-days constitute a substantial part of total assets of many insurance companies. Method of valuation of investments followed by an insurance company may, therefore, have a significant effect on its Balance Sheet and Profit and Loss Account. The auditor should examine whether the method of accounting followed by the insurance company in respect of investments, including their year-end valuation, is appropriate.

The auditor should examine the manner of accounting for investments in the context of the guidelines of the Insurance Regulatory and Development Authority (discussed earlier in this Chapter) and the accounting policy followed by the insurance company in respect of investments. The auditor should examine the appropriateness of accounting policies followed by the insurance company. In case any of the accounting policies is not appropriate, the auditor should consider the effect of adoption of such policy on the financial statements and, consequently, on his audit report.

A change in the method of valuation of investments constitutes a change in accounting policy and adequate disclosure regarding the fact of the change along with its financial effect should be made in the balance sheet.

The auditor should examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the insurance company has opted for receipt of income through the Electronic Clearing Service.

There may be cases where the certificates of tax deduction at source (TDS) received along with the interest on investments are found missing. This increases the incidence of tax on the insurance company. The auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the insurance company.

12.8.2 Cash and Bank Balances - Cash and Bank balances at Branch Office/Divisional Office level also constitute significant items related to balance sheet. The auditor should apply the following audit procedures for verification of claims.

- ◆ The auditor should physically verify cash balance collection and imprest for meeting day to day expenditures, postage stamps balance, revenue, policy, licence fees, franking machine balance. The auditor should also obtain a certificate from the management for the above mentioned balances as at the balance sheet date. If for some reason, the physical verification of the above on the balance sheet date is not possible then the same can be done at a subsequent date and by way of backward calculations, cash in hand at the balance sheet date can be verified.

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- ◆ The auditor should also check whether late collections of cash and cheques on the last working day of the financial year, which could not be deposited into bank account on the same day, have been identified and booked as Cash in Hand and Cheques in Hand Account, respectively.
- ◆ The auditor may apply test check on the bank transactions.
- ◆ The auditor should also check Bank Reconciliation statement and long outstanding entries therein.
- ◆ The auditor should obtain confirmation of Bank Balances for all operative and inoperative accounts.
- ◆ The auditor should physically verify Term Deposit Receipts issued by bankers.
- ◆ The auditor should verify the deposits and withdrawals transactions at random and check whether the Account is operated by authorised persons only
- ◆ The auditor should verify the subsequent realisations for all items appearing in the reconciliation.
- ◆ In case of funds, in-transit, he should verify that the same are properly reflected as part of bank balance.

12.8.3 Outstanding Premium and Agents' Balances -The following are the audit procedures to be followed for verification of outstanding premium and agents' balances:

- ◆ Scrutinise and review control account debit balances and their nature should be enquired 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 adjustment. Notes of explanation may be obtained from the management in this regard.
- ◆ Check age-wise, sector-wise analysis of outstanding premium.
- ◆ Verify whether outstanding premiums have since been collected.
- ◆ Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

12.8.4 Provision for Taxation - The steps to be conducted by the auditor for audit and verification are given below:

- (i) The auditor should check whether the provision for taxation has been made after taking into account the above specific provisions applicable to insurance companies carrying on general insurance business.
- (ii) 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,

1938 to be furnished to the Controller of Insurance, is taken but also all the other accounts furnished by the company to the Controller of Insurance is taken into account.

- (iii) The auditor should assess the past trend regarding the approach of the Income Tax Department, the decision of the various appellate forums including the High Court and the Supreme Court *vis-a-vis* the computation made.
- (iv) The compliance with the provisions of Chapter III provisions the Income Tax Act, 1961 which provides for income which do not form part of total income is also to be seen.
- (v) The auditor should see whether deductions 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.
- (vi) The auditor should examine whether income computation relating to foreign branches and other income earned outside India is dealt with properly as per the double taxation avoidance agreement, if any, entered into with those countries.
- (vii) It should be seen whether the exemption provision relating to tax deducted at source from certain categories of income as exempted under section 35A of the General Insurance (Business Nationalisation) Act, 1972 has been properly availed.
- (viii) Also, the auditor should check whether the grossing up of TDS relating to the income has been properly done for the propose of computation of taxable income.
- (ix) The auditor should ensure that the provisions of the Income Tax Act, 1961 regarding the tax to be deducted at source have been properly complied with, relating to the payments / credits for which the TDS provisions of the Income Tax Act and applicable and the amount so deducted are remitted within the stipulated time. Also check TDS implication on the interest paid /payable and included on claim settlement / outstanding claims.
- (x) 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.
- (xi) The auditor should see the system of service tax collection and the payment to the statutory authorities and the internal system including the filing of statutory returns.
- (xii) The examination of sales tax implication on the sale of salvage should also be seen as it is applicable to the respective states and the past trend in this regard.
- (xiii) The auditor should check the liability under the VAT and whether provision for adequate amount has been made in the books or not.
- (xiv) The auditor should verify that adequate provision has been made for additional liability relating to earlier years for which demands have been received in the current year and where the company has gone into appeal, the fact that no provision has been made and that an appeal has been preferred has to be disclosed in the notes to accounts.

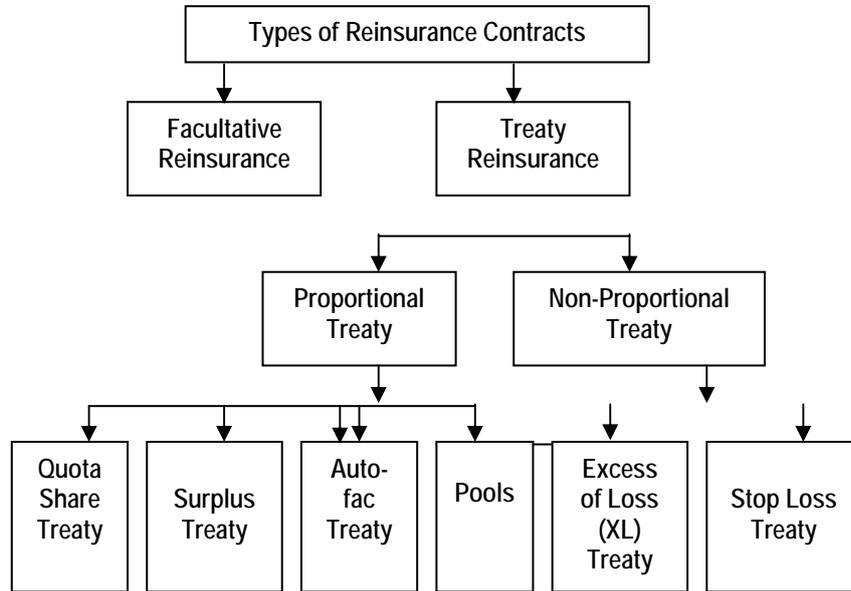
12.8.5 Unexpired Risks Reserve - The need for Unexpired Risks Reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts on a particular date, not all risks under policies expire on that date. Many policies normally extend beyond this date into the following

year during which risks continue. In other words, at the closing date, there is unexpired liability under various policies which may occur during the remaining term of the policy beyond the year end. The effort involved in calculating unexpired portion of premium under each policy is very time consuming therefore, a simple formula to derive a percentage of premium income to be allocated to reserve for unexpired risks is adopted. According to the requirements of the Insurance Act, 1938, for the purpose of maintaining solvency margin, it is sufficient if the provision is made for unexpired risks at 50 per cent for Fire, Marine Cargo and Miscellaneous business except for Marine Hull which has to be 100 per cent. It may be mentioned that the insurance companies are governed by the provisions of Section 44 of the Income Tax Act, 1961. In this regard Rule 5 of the First Schedule to the Income Tax Rules-Computation of Profit & Loss of General Insurance Business-provides for creation of a reserve for unexpired risks as prescribed under Rule 6E of the said rules. According to this Rule, the insurance companies are allowed a deduction of 50 per cent of net premium income in respect of Fire and Miscellaneous Business and 100 per cent of the net premium income relating to Marine Insurance business. In view of this, the reserves are created at the rates allowed under the Income -tax Act.

12.9 Reinsurance

A reinsurance transaction may be defined as an agreement between a 'ceding company' and a 'reinsurer' whereby the former agrees to 'cede' and the latter agrees to accept a certain specified share of risk or liability upon terms as set out in the agreement. A 'ceding company' is the original insurance company which has accepted the risk and has agreed to 'cede' or pass on that risk to another insurance company or the reinsurance company. It may, however, be emphasised that the insured does not acquire any right under a reinsurance contract. In the event of loss, the insured's claim for full amount is against the original insurer only. The original insurer in turn, lodges a claim with the reinsurer.

12.9.1 Type of Reinsurance Contracts - There are broadly two types of reinsurance contracts, viz., facultative reinsurance and treaty reinsurance. A diagrammatic presentation is as below:



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.
- (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.

Treaty Reinsurance - Under this type of reinsurance, a treaty agreement is entered into between the ceding company and the reinsurer(s) where reinsurances are within the limits of the treaty. These limits can be monetary, geographical, section of business, etc. Under this contract, it is obligatory for the reinsurer to accept all risks within the scope this treaty and it is obligatory for the ceding company to cede risks in accordance with the terms of the treaty. In the case of treaty reinsurance contracts, the insurer generally prepares a statement of treaty reinsurances accounts, either on quarterly basis or on half-yearly basis. These statements are

sent to the re-insurer for the purpose of reconciliation of claims lodged under the reinsurance contracts, out standing claims, claims paid and claims paid in advance. It may be noted here that the treaty reinsurance contracts generally provide that in the event of any large claim being lodged with the insurer, the re-insurer shall make the payment even before the claim is finally settled or the statement of treaty reinsurance is received by the reinsurer. The reinsurer, in such cases, treats the amount paid to the insurer as 'advance against claim'. The Advance against Claim Account is squared up as and when the claim is settled and the information of this settlement is sent to the reinsurer through statement of treaty reinsurances. Such payments by the reinsurer are called Cash Loss Payments. Treaties can also be divided into two categories, viz., proportional treaties and non-proportional treaties.

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 be further classified as follows:

Quota share treaty - Under this treaty, the ceding company binds itself to cede a fix percentage of all policies issued by it under a defined scope of business covered by the agreement. The accounting under this treaty is simpler than any other form of treaties. The advantage to the reinsurer under this treaty is that the reinsurer receives the same proportion of all business of the treaty class defined under the treaty. In other words, there is no selection against him. The advantage to the ceding company under this treaty is that, it cannot vary its retention/line for any particular risk, and therefore, it may have to pay premiums even on small risks which could have been retained by the ceding company itself. The use of this treaty is appropriate when a company commences business at a branch where no relevant data is available.

Surplus Treaty - Where a company cedes those amounts which it cannot or does not want to retain for its net account, such type of contract is known as surplus reinsurance treaty. If certain risk is totally retained, no surplus is left to be ceded. Surplus is always determined in multiples of ceding company's retention. A company can arrange more surplus treaties by having, say, second surplus treaty or third surplus treaty, etc. An example is given below:

Sum Assured	₹ 500 lakhs
Line	₹ 5 lakhs
Surplus	₹ 495 lakhs

If first surplus treaty is 10 lines, it would cede ₹ 50 lakhs to the treaty and the balance of ₹ 445 lakhs would have to be ceded to other treaty arrangements.

Auto-fac Treaty - Under this treaty, a ceding company may reinsure upto a defined limit after cession of its surplus treaties. It is obligatory for the reinsurer to accept cessions within the purview of the agreement. It, thus, resembles a facultative reinsurance treaty as the acceptance is obligatory and in many instances, the details of the risks are submitted by way of a Borderaux.

Pools - More than one insurer may form a Pool under an agreement whereby its members cede a pre-determined proportion of a particular category of business directly written by them

into the Pool. They also share the aggregate premiums and claims in the proportion and the share of premium ceded by each member. In India, the examples of this system are Indian Market Fire Pool and Hull Pools.

Non-Proportional Treaties - Such treaties are characterised 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 proportional reinsurance. The following are the other characteristics of non-proportional treaties:

- (i) Premium is not calculated on each cession, but on the whole portfolio of the ceding company.
- (ii) The premium rate is predetermined.
- (iii) Cost of reinsurance can vary substantially each year, depending on the premium income, loss ratio and reinsurance market situations.
- (iv) Normally no commission is paid.

Non-Proportional Treaties can be further classified into following categories.

Excess of Loss (XL) Treaties - In this type of treaty, the reinsurer's liability arises only when a claim exceeds a predetermined figure relating to a specific branch of the ceding company's business or to its entire business. The Treaty would provide for maximum liability as well as the amount upto which the ceding company would bear the loss itself, which is called the 'Underlying Limit'. The XL cover can also be arranged for an unlimited amount in excess of the underlying limit.

Excess of loss cover on prevent basis - In this type of cover, in case as a result of one event several risks are effected, the loss under each risk is arrived at separately and the underlying limit is applied to each risk to determine the liability of the insurer. This is also known as 'Working Excess of Loss Cover'.

Excess of loss cover on non-prevent basis- In this type of cover, losses resulting from one event are considered together and aggregate amount of loss is determined and one loss underlying limit is deducted from the aggregate amount of the loss to determine the liability of the excess of loss reinsurer. This type of cover provides protection to an insurer against the numerous losses caused by one or the same event such as cyclone, earthquake, etc. This type of cover is also, therefore, known as 'Catastrophic Covers'.

Stop loss treaties - This is also known as 'Excess of Loss Ratio Cover' and it protects the company from losing more than a specified amount for a given class of business. Normally, the amount is fixed in relation to the ceding company's annual premium income for the class of business and is represented as a percentage. Thus, the reinsurer is liable for the losses which exceed the agreed percentage of loss ratio, until the limit of liability is reached which is expressed in the form of loss ratio. Such a treaty protects the annual results of a company in one branch against negative deviation due to increase in the number and cost of claims/losses.

12.9.2 Verification of Re-Insurance Inward - Under Sub-regulation 4 of the IRDA (General Insurance Reinsurance) Regulations, 2000, every insurer desirous of writing inward

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reinsurance business should have a well defined underwriting policy. The decisions on acceptance of re-insurance should be taken by persons with good knowledge and experience, keeping in view the financial risk involved in those transactions. The insurer is required to file with the Authority, a note on its underwriting policy and any changes therein from time to time. The auditor should apply the following verifications measures for re-insurance inward transactions:

- ◆ Re-Insurance Inward underwriting should be as per the norms and guidelines prescribed by the Insurance Act, 1938 and IRDA Regulations. It is necessary to ensure that the inward reinsurance arrangements and acceptances, both Indian and foreign are done as per the prescribed parameters applicable for the particular year.
- ◆ The auditor should check that domestic inward acceptances are in accordance with the approved programme.
- ◆ The auditor should verify whether re-insurance inward acceptance, both Indian and foreign, are as per arrangements / agreements entered into with Indian and foreign insurance companies.
- ◆ The auditor should also verify whether the policy adopted for booking the accounts is on "receipt" basis or "due" basis with the appropriate basis of estimation towards accounts not received and that the basis of estimation is fair and consistently applied and properly disclosed.
- ◆ 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 acceptances.
- ◆ The auditor should check the accounts for closure of any underwriting year, with portfolio withdrawals as per the terms and conditions agreed.
- ◆ The auditor should evaluate the system and practice adopted in recognising the foreign currency transaction and also whether it is in accordance with the Accounting Standard (AS)-11, Accounting for Effects of Changes in Foreign Exchange Rates.
- ◆ The auditor should verify whether profit commission has been calculated as per the agreement and terms and conditions and all 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.
- ◆ The auditor should also verify whether the Foreign Inward acceptance components, consisting of premium, commission, brokerage and other expenses, claims consisting of paid claims opening and closing outstanding claims etc., have been recorded and accounted as per the accounts rendered by the companies. 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 accounts submitted have been done at the appropriate conversion rates as per Accounting Standard (AS)-11.

- ◆ The auditor should examine whether the outstanding claim figures have been properly obtained well in time, under proper systematic arrangements and sufficient provisioning has been made for all the outstanding claims. The auditor should see that regarding foreign inward, appropriate provisioning is done after adopting prescribed conversion rate to the Indian rupee. The auditor should ensure that confirmation regarding the outstanding claims have been received in respect of all inward arrangements.
- ◆ As per IRDA (General Insurance-Reinsurance) Regulations, 2000, every insurer is required to make provision for outstanding claims for all reinsurance arrangements accepted on the basis of loss information advices received from brokers /cedants and where such advices have not been received, on an actuarial estimation basis. In addition, every insurer has to make an appropriate provision for 'Incurred but Not Reported (IBNR)' claims on its reinsurance accepted portfolio on actuarial estimation basis. This aspect has to be looked into as this may result in a lot of difference in the financial results of the company.
- ◆ Closing balances of the re-insurer's accounts should be reconciled and the confirmation of balances should be obtained from all the companies.
- ◆ The auditor must ensure that foreign inward accounts balances have been re-stated at the prevailing value at the year end and that difference arising out of re-statement has been taken to Profit and Loss Account.
- ◆ The auditor should verify the requirement of provision / write off of reinsurance inward balances based on the doubtful nature of recovery, if any.
- ◆ The auditor should check whether Indian inward balances including with the GIC have reconciled and identical balances arrived at and affect, if any, due to co-insurance transactions should also be looked into.

12.9.3 Verification of Re-Insurance Outward -The following steps may be taken by the auditor in the 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 of re-insurance underwriting for outward cessions 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 cessions have been made as per the agreements entered into with various companies.
- ◆ It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.

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- ◆ It should also be seen whether the commission on cession has been calculated as per the terms of the agreement with the re-insurers.
- ◆ 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.
- ◆ 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 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.
- ◆ 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 gross to net premium, claims paid and outstanding claims to ensure comparative justification.
- ◆ The auditor should also check that the re-insurers balance on cessions 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 re-insurers 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 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.
- ◆ 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.

12.10 Co-Insurance

Where the insured chooses to have more than one insurer for the same transaction of risk, it would amount to coinsurance. The concept of co-insurance emerges, when there is a predetermined set of understandings, leader of the business receives the premium and issues policy with a co-insurance clause in the policy and the referred leader also settle the claims to the insured in case of the occurrence of claims. Balances pertaining to other companies relating to premiums and claims are accounted under co-insurance as "Amounts due to / due from" other insurance companies.

Balances are settled in periodical meetings and exchange of statements as agreed between the companies. Suitable slot can be provided in the systems to incorporate co-insurance requirements. Most of the practice in accounting and settlement of co-insurance transactions are industry specific and insured specific. Hence, system may suitably be designed to accommodate all the possibilities of co-insurance accounting and settlements.

The auditors should get information from the agreement arrived at the Insurance Council, where the insurance companies may chose to be the members. (Wherever the concept of Insurance Council is in place). Members of the Insurance Council could arrive the mutually agreeable terms and norms of entering into coinsurance agreement and the norms for settlement of dues. 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

The auditor should go through the understanding of the Council and ensure that the risks are covered as per the terms and conditions with adequate consideration and proper settlement.

12.11 Solvency Margin

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-

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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.

12.11.1 IRDA Regulations - Sub section (3) of Section 64V of the Act requires that every insurer should value the assets and liabilities in the manner laid down by the Section 64V and in accordance with the regulations which may be made by the Authority in this behalf.

The Authority has issued IRDA (Assets, Liabilities and Solvency Margin of Insurers) Regulations. The Regulations lay down manner of valuation of assets and liabilities, the forms in which assets and liabilities are to be disclosed, the manner of determination of solvency margins and the format of certificate to be signed by the auditors.

Every Insurer is required prepare a statement of value of assets in "Form IRDA-Assets-AA." A statement of the amount of liabilities in case of general insurance business is to be prepared in "Form HG" and a statement of Solvency Margin in "Form KG" as specified in the Insurance Regulatory and Development Authority (Assets, Liabilities and Solvency Margin of Insurers) Regulations. The statement of assets, liabilities and solvency margin are to be certified by an auditor and filed by the insurance company with the Authority within six months from the end of the period to which they refer to along with the audited accounts and statements. The salient features pertaining to the valuation of assets are discussed below:

12.11.2 Statement of Solvency Margin -Every insurer is required to determine the required solvency margin, the available solvency margin and the solvency ratio in the Form KG. The statement of solvency margin is to be prepared in accordance with Section 64 VA of the Insurance Act, 1938 and the same is to be certified by the auditor.

12.12 Trade credit insurance

"Trade Credit Insurance business" means the business of effecting contracts of insurance in respect of trade credit insurance transactions.

"Trade credit insurance" means insurance of suppliers against the risk of non-payment of goods or services by their buyers who may be situated in the same country as the supplier (domestic risk) or a buyer situated in another country (export risk) against non-payment as a result of insolvency of the buyer or non-payment after an agreed number of months after due-date (protracted default) or non-payment following an event outside the control of the buyer or the seller (political risk cover). Political risk cover is available only in case of buyers outside India and in countries agreed upon at the proposal stage.

"Trade Credit Insurance transaction" means a transaction between two persons for supply of goods or services on open and agreed terms.

"Trade Credit insurance policy" is a conditional insurance contract between two parties (insurer and seller) that cannot be traded and is always directly related to an underlying trade transaction, which is either the delivery of goods or of services. The correct fulfilment of this trade transaction and satisfaction of the contract terms which is essential for credit cover to exist.

12.12.1 Basic Requirements of a Trade Credit Insurance Product: An insurer shall offer trade credit insurance product only if all requirements mentioned below are met:

1. Policyholder's loss is non-receipt of trade receivable arising out of a trade of goods or services.
2. Policyholder is a supplier of goods or services in consideration for a fair market value.
3. Policyholder's trade receivable does not arise out of factoring or reverse factoring arrangement or any other similar arrangement.
4. Policyholder has a customer (*i.e.* Buyer) who is liable to pay a trade receivable to the policyholder in return for the goods and services received by him from the policyholder, in accordance with a policy document filed with the insurer.
5. Policyholder undertakes to pay premium for the entire Policy Period.
6. Any other requirement that may be specified by the Authority from time to time.

12.13. Compliance with Corporate Governance Guidelines ("CG Guidelines") CIRCULAR NO. IRDA/F&A/CIR/CG/081/05/2011, DATED 2-5-2011

Attention is drawn to the Corporate Governance Guidelines issued by the Authority *vide* Circular no. IRDA /F&A/ CIR/025/2009-10, dated 05th August, 2009, and Circular No. IRDA /F&A/CIR/ F&A/014/01/2010, dated 29th January, 2010.

The following additional stipulations shall form part of the Guidelines:-

I. Annual Filing of Compliance Status:

- (a) All insurers are required to file a Report on status of compliance with the C G Guidelines on an annual basis w.e.f. the Financial Year 2010-11. This report shall be filed within 90 days from the end of the Financial year (*i.e.*, before 30th June).
- (b) Clause 9 of the CG Guidelines requires confirmation of disclosures made in the Annual Accounts. In such instances, where the finalization of Annual Accounts extends beyond 90 days of the close of the financial year, the status on disclosure in the Financial Statements as required under the aforementioned clause may be made within 15 days of adoption of the Annual Accounts by the Board of Directors of the insurers. This is in line with the stipulations issued by IRDA *vide* Circular No. IRDA/F&A/013/2005-06, dated 9th June, 2005.

II. Filling up of the Vacancy to the Post of Independent Director on the Board:

Clause 5.1 of the CG Guidelines lays down the requirements regarding appointment of a minimum number of independent directors on the Board of Directors of an insurer. These stipulations are in line with Section 48 of Insurance Act, 1938.

All insurers are required to ensure compliance with the stipulations regarding the minimum number of independent directors at all times. In case, the number of independent directors falls below the minimum requirement laid down, the vacancy shall be filled up within a maximum period of 180 days, under intimation to the Authority.

III. Optional Committees: Clause 7 of the CG Guidelines provides for the formation of following three optional committees:

- (1) Remuneration Committee
- (2) Nomination Committee
- (3) Ethics Committee

It is further clarified that though the formation of such Committees is optional, once these are in place, the insurer is required to comply with the requirements on the "Role and Responsibilities" of such Committees as laid down in the said clause of the CG Guidelines. Insurers are advised to initiate steps to ensure compliance with respect to such Committees.

APPENDIX I

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

I. 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.

II. System of Financial Control

1. Examine the delegation of financial powers and indicate whether these are clearly and legally made within the company. If not, describe the defects in the delegation

of powers and suggest remedial measures.

2. Indicate whether the cash and imprest balances were physically verified during the year on a regular basis by an authorised officer? Highlight the inadequacies in this regard, if any.
3. Whether transfers of surplus funds are being made on a timely basis and whether these are being properly monitored?
4. Examine whether the system of the company insures adequate control over issue and custody of critical items of stationery, e.g., cover notes, policy documents receipts and acknowledgements relating to risk accepted, etc? If not, describe the inadequacies.
5. Give your comments on Internal Audit system stating whether its reporting status, scope of work, level of competence, etc. are adequate? If not, describe the shortcomings thereof. Is there an adequate compliance mechanism on internal audit observations?
6. Indicate the serious lacunae in the system of internal control which have come to your notice during audit.

III. Investments (Applicable only at H.O.)

1. Indicate whether the Board of Directors of the company laid down on investment policy? If yes, please indicate the following:-
 - (a) Is the policy in accordance with the laws, rules and regulations applicable to the company?
 - (b) In your opinion, are there any defects in the policy?
 - (c) Has the company followed it in case of all material investments made during the year?
 - (d) Were the investments made by the company in its best interest?
2. Does the company have adequate system of periodic physical verification of investments and reconciliation thereof with books? Have the discrepancies been properly dealt with?
3. Does the system of the company ensure proper recording of rights, entitlements and options on investments held? Are adequate records maintained in support of exercise/non exercise of such rights, etc.?
4. Does the system of the company ensure recording of accrual of dividend, interest and other yields on investments and for follow up of the amounts accrued but not received?
5. In the case of investments matured and income due but not received/collected, is satisfactory explanation available for non-receipt/non-collection?

IV. Loans (Applicable only at H.O.)

1. Indicate whether the Board of Directors of the company has laid down a policy regarding of loans. If yes, please indicate the following :-
 - (a) Is the policy in accordance with the laws, rules and regulations applicable to the company?
 - (b) In your opinion, are there any defects in the policy?
 - (c) Has the company followed it in the case of all material loans made during the years?
 - (d) Were the loans made by the company in its best interest?
 - (e) Has adequate provision been made in the accounts in respect of bad and doubtful loans? If not, describe the failures.
 - (f) Does the company have an effective system of identifying non-performing loans? Does the company monitor such loans effectively?
 - (g) Has the company taken adequate steps against the defaulters during the year? If not, indicate significant instances of failures.

V. Revenue Accounts

1. Does the company has an effective system to ensure that premiums for risks assumed/accepted during the year for various classes of business are properly computed and accounted for?
2. Is the system of collections of premium on policies issued adequate? If not, give instances of major violations of relevant legal provisions and prescribed procedures.
3. Have the norms for determining premium for non-tariff business been laid down by the company and are these followed by divisions/branches booking the business?
4. Have you come across instances of prohibited/declined risks having been accepted in excess of the delegated authority?
5. In respect of system relating to claims, comment on the following aspects, giving instances of significant deviations/failures in each case.
 - (a) Are claims promptly recorded in the claims intimation register for each class of business? Is the liability of the company ascertained/ assessed expeditiously?
 - (b) Are surveyors appointed and their preliminary/final survey reports obtained within a reasonable time?
 - (c) Is collection and accounting of salvage as well as its disposal expeditious?
 - (d) Are close proximity claims, i.e., claims within a short period after commencement of the risk, identified? Are the procedures for processing of such claims effective/
 - (e) Are pending claims reviewed periodically and follow-up action taken in appropriate cases?

6. Does the system of the company ensure that claims are recorded net of co-insurance at the D.O./branch and net of re-insurance as per arrangement with other insurers at the Head Office?
7. Is the system of monitoring the accepted or ceded business and accounting of premiums and claims in connection therewith adequate? Indicate major defects.
8. Are balances under accepted treaties periodically reconciled and action taken for outstanding recoveries?
9. Does the system of the company ensure proper recording of incoming and outgoing co-insurance transactions and periodic reconciliation of co-insurers balances?
10. Does the system of the company ensure periodic reconciliation of ledger balances relating to premiums and claims with the relevant figures as per the business and claims registers as communicated by divisions in the underwriting returns for purpose of re-insurance?
11. Were the re-insurance treaties entered into by the company in its best interest? Indicate cases of re-insurance treaties which have resulted in heavy losses continuously.

VI. Miscellaneous

1. Are the (i) Premium deposit accounts, (ii) Bank guarantee account, (iii) Agent's balance accounts (iv) Outstanding premium accounts, (v) Amount due to and from other persons/bodies carrying on insurance business accounts, (vi) Treaty inwards and outwards control accounts , (vii) sundry debtors and creditors accounts including outstanding claims, regularly reviewed and pursued for clearance/adjustment? Have confirmations been obtained of such outstanding accounts. ? In the case of credit Balance including premium deposits, sundry deposits and agents balances, are appropriate premium adjustments made for risks assumed, if any ?
2. Were there any special features in the year which have affected the results shown by the profit and Loss Account substantially ? If so, give details.
3. Are there any other significant matters which in your opinion deserve the attention of the management?

Annexure -A

(This information is factual and should be obtained from the Management)

1. Indicate the areas where the company has computerised the accounts system. Have the General and Application controls been reviewed periodically to derive assurance that the system is producing results that can be relied upon by the auditors? State the deficiencies reported by internal auditors/statutory auditors alongwith the remedial measures being taken by the management.
2. Are the accounts of the company in arrears? If so, state the reasons therefor and the action taken/being taken to bring the accounts up-to-date.

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3. Please comment on operation of foreign branches/ agencies with relevant details. In case of adverse results remedial measures taken and results thereof should be described.
4. What are non-performing investments? Please indicate the cost, book value and market value of such investments.
5. What is the average yield on investments in last three years?
6. What percentage of loans was considered doubtful at the end of each the three preceding years and the absolute amount thereof?
7. Give age-wise break-up of outstanding claims for each class of business (numbers and amount).
8. List out top 30 claims (above ₹ 5 lakhs each) provided/settled during the year (10 for each class of business).
9. Have any cases of frauds/embezzlements/ misappropriation comes to light during the year? If so, give details