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Audit of General Insurance Companies

Question 1

ABC & Co., Chartered Accountants are the Auditors of Just Care General Insurance Company Limited. As on March 31, 2014 the Management made a provision for claims outstanding. Enumerate the steps to be taken by the Auditor while verifying the "Claims Provision".

(6 Marks, November, 2014)

Answer

Verification of "Claims Provision" in the case of a General Insurance Company: 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.

(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.

(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.

(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.

(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.

Question 2

M/s ABC & Co., a CA firm was appointed as the auditor of 'Always Safe General Insurance Ltd.' Advise them how they will verify outstanding premium and agent's balances.

(6 Marks, May, 2014)

Or

Write a short note on Audit procedure in respect of "Outstanding premium and Agents balance" in Insurance company. *(4 Marks, November, 2011)*

Or

Write a short note on Guidance note on Verification of Outstanding Premium and Agents' Balances. *(5 Marks, November, 2010)*

Or

As the auditor of an Insurance company state the audit procedure you would follow to verify outstanding premium and agents balances. *(4 Marks, November, 2008)*

Or

State the procedure for verification of Agents' Balances in the course of audit of a General Insurance Company. *(4 Marks, November, 2004)*

Answer

Verification of Outstanding Premium and Agents Balances: The following are the audit procedure to be followed for verification of outstanding premium and agents balances in the case of Insurance Company -

(i) Scrutinize and review control account debit balances and their nature should be enquired into.

(ii) Examine in operative balances and treatment given for old balances with reference to company rules.

(iii) Enquire the reasons for returning the old balances.

(iv) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.

(v) Check age-wise, sector-wise analysis of outstanding premium.

(vi) Verify whether outstanding premiums have since been collected.

(vii) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.

Question 3

ABC Limited, an Indian insurance company carrying on general insurance business, is facing liquidity problems and, therefore, it has decided to maintain deposits under section 7 of the Insurance Act, 1938 at one percent of total gross premium written in India. The company thinks that it is sufficient, as the company has a Paid-up Capital of ₹ 150 Crores. As an Auditor of ABC Limited what would be your suggestion to the company for compliance of Insurance Act and rules and regulations made there under? *(4 Marks, November, 2013)*

Answer

Maintaining Deposits under section 7 of the Insurance Act, 1938: 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.

In the given case, ABC Limited has decided to maintain deposits at one percent of the total gross premium written in India, which is violation of the Section 7 of the Insurance Act, 1938. The contention of the company that it has a paid up capital of ₹ 150 Crores would not make the difference.

Question 4

As at 31st March 2013 while auditing Safe Insurance Ltd you observed that a policy has been issued on 25th March 2013 for fire risk favouring one of the leading corporate houses in the country without the actual receipt of premium and it was reflected as premium receivable. The company maintained that it is a usual practice in respect of big customers and the money was collected on 5th April, 2013. You further noticed that there was a fire accident in the premises of the insured on 31st March 2013 and a claim was lodged for the same. The insurance company also made a provision for claim. Please respond.

(4 Marks, May, 2013)

Answer

Provision for Claim: 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.

In view of the above, the insurance company is not liable to pay the claim and hence no provision for claim is required.

Question 5

Write a short note on Solvency Margin. *(4 Marks, May, 2012)*

Or

Write a short note on Solvency margin in case of an insurer carrying on general insurance business. *(4 Marks, November, 2006)*

Answer

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-section (2C) of Section 64A states that if an insurer fails to comply with the requirements of the Insurance Act, 1938, it shall deemed to be insolvent and may be wound up by the Court.

Question 6

State the disclosure requirements in respect of contingent liabilities in the notes to the Balance Sheet of a General Insurance Company. *(4 Marks, May, 2011)*

Answer

Disclosure Requirements in respect of Contingent Liabilities in the Notes to the Balance Sheet of a General Insurance Company: The following shall be disclosed by way of notes to balance sheet in respect of Contingent Liabilities-

(i) Partly paid up investments.

(ii) Underwriting Commitments outstanding.

(iii) Claims, other than those under policies, not acknowledged as debts.

(iv) Guarantees given by or on behalf of the Company.

(v) Statutory demands/liabilities in dispute, not provided for.

(vi) Reinsurance obligations to the extent not provided for in the accounts.

(vii) Others (to be specified).

Question 7

While auditing the claims paid in respect of a General Insurance Company what aspects need to be looked into? *(6 Marks, May, 2010)*

Or

What are the specific areas to which you will give your attention while examining "Claims Paid" by a General Insurance Company. *(8 Marks, May, 2004)*

Answer

Audit of the Claims Paid in respect of a General Insurance Company: The following are the aspects needs to be examined in respect of claims paid-

(i) In case of co-insurance arrangements, claims paid have been booked only in respect of the company's share and the balance has been debited to other insurance companies;

(ii) In case of claims paid on the 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) Claims paid have been duly authorized and acknowledged by the claimants;

(iv) Salvage recovery has been in accordance with the procedure prescribed 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 has 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) In case of final settlement of claims, the claimant has given unqualified discharge note, not involving the company in any further liability in respect of the claim; and

(viii) That the figures of claims, wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.

Question 8

Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward in case of a General Insurance Company. *(5 Marks, November, 2009)*

Answer

Verification of Re-insurance Outward: The following steps may be taken by the auditor in the verification of re-insurance outward -

(i) The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.

(ii) The auditor should check whether the pattern of reinsurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.

(iii) The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.

(iv) The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.

(v) It should also be seen whether the outward remittances to foreign re -insurers have been done as per the foreign exchange regulations.

(vi) It should also be seen whether the on cessions have been calculated as per the terms of the agreements with the re-insurers.

(vii) The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.

(viii) The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.

(ix) The auditor should also verify whether the claims paid item appears in outstanding claims list by error. This can be verified at least in respect of major claims.

(x) He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.

(xi) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.

(xii) The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.

(xiii) The auditor should also check that the re-insurers balance on cessions and whether the sub ledge balances tallies with the general ledger balance.

(xiv) The auditor should review the individual accounts to find out whether any balance requires provisioning/write off or write back.

(xv) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.

(xvi) He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-avis the reinsurance inwards outstanding losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.

(xvii) Any major event after the balance sheet date which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought out suitably.

Question 9

RQ Insurance Ltd. has made a provision of 25% on unexpired risks reserve in its books. Comment. *(5 Marks, May, 2008)*

Answer

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.

In other words at the closing date, there is an unexpired liability under various policies which may occur during the remaining term of the policy beyond the year end.

The minimum amount of unexpired risks reserve to be created is determined as per the Insurance Act, 1938 at a specified percentage of net premium as under:

(i) for marine hull insurance – 100% of net premium

(ii) For fire, marine cargo and miscellaneous business – 50% of net premium.

Provisions of income Tax Act 1961 and Income Tax rules 1962 permit deduction of above reserves at the prescribed rates.

Conclusion: In the given case, the Auditor of RQ Insurance Ltd should qualify his report as the company has made a provision of only 25% against the prescribed minimum of 50% or 100% as mentioned above, thereby resulting in overstatement of profit.

Question 10

State the procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company. *(10 Marks, May, 2007)*

Answer

Procedure to Determine the Value of Listed and Unlisted Equity Securities and Derivative Instruments of an Insurance Company: Equity securities and derivative instruments that are traded in active markets, shall be measured at fair value as at the Balance Sheet date. Fair value will be the lowest of the last quoted closing price of the stock exchanges where the securities are listed. The insurance company shall assess on each Balance Sheet date whether any impairment of listed security/derivative instruments has occurred.

An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and sellers is normal and the prices are publicly available.

Unrealized gains/losses arising due to changes in fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account'. The 'profit' on sale of investments' or 'loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading Fair Value Change Account in respect of particular security and being recycled to statement of profit and loss on actual sale of that listed security.

Any credit balance in Fair Value Change Account will not be available for distribution as dividends. Also any debit balance in such an account shall be reduced from profits/free reserves while declaring dividends.

At every Balance Sheet date, impairment loss should be recognized as an expense to the extent of the difference between the re-measured fair value of the security and its acquisition cost as reduced by any previous impairment loss already recognized. Any reversal of impairment loss earlier recognized as an expense, should be recognized in the Revenue Account/Statement of Profit and Loss.

Unlisted and other than actively traded equity securities and derivative instruments will be measured at historical costs. Provision shall be made for diminution in value of such investments. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of investments over its carrying amount. The increased carrying amount of the investments due to reversal of the provision shall not exceed the historical cost.

Question 11

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

(8 Marks, November, 2005)

Answer

Steps in Audit of Re-insurance Ceded:

(i) Evaluate internal control system in the area of reinsurance ceded to ensure determination of correct amount for reinsurance ceded, proper valuation of assets and liabilities arising out of reinsurance transaction and adherence to legal provisions and regulations.

(ii) Ascertain whether adequate guidelines and procedures are established with respect to obtaining reinsurance.

(iii) Reconcile reinsurance underwriting returns received from various units with the figures of premium, claims paid and outstanding claims for the company as a whole.

(iv) Examine whether commission on reinsurance ceded is as per the terms of the agreement with the re-insurers.

(v) Examine the computation of profit commission for automatic treaty arrangements in the light of the periodic accounts rendered and in relation to outstanding loss pertaining to the treaty.

(vi) Examine whether loss recoveries have been claimed and accounted on a regular basis.

(vii) Examine whether outstanding losses recoverable have been confirmed by re-insurers.

(viii) Examine whether remittances to foreign re-insurers are as per foreign exchange regulations.

(ix) Examine whether confirmations have been obtained regarding balances with re-insurers.

(x) Review individual accounts of re-insurers to evaluate whether any provision/write off or write back is required.

Question 12

"In an audit of an insurance company, the Receipts and Payments Account is also subjected to audit". Comment on this statement in brief. *(6 Marks, May, 2005)*

Answer

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

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

(i) report whether the receipts and payments account of the insurer is in agreement with the books of account and returns;

(ii) express an opinion as to whether the receipts and payments account has been prepared in accordance with the provisions of the relevant statutes; and

(iii) express an opinion whether the receipts and payments account give a true and fair view of the receipts and payments of the insurer for the financial year/period under audit.

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