

FINANCIAL STATEMENTS OF INSURANCE COMPANIES

UNIT-1:INTRODUCTION TO INSURANCE BUSINESS

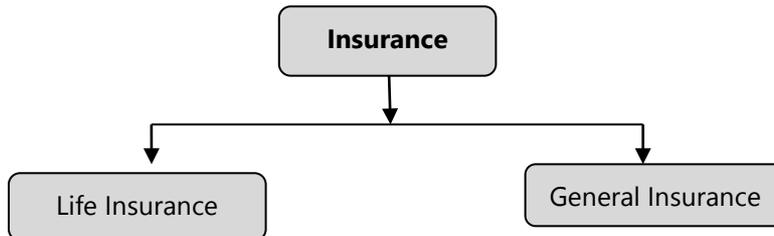
LEARNING OUTCOMES

After studying this chapter, you will be able to:

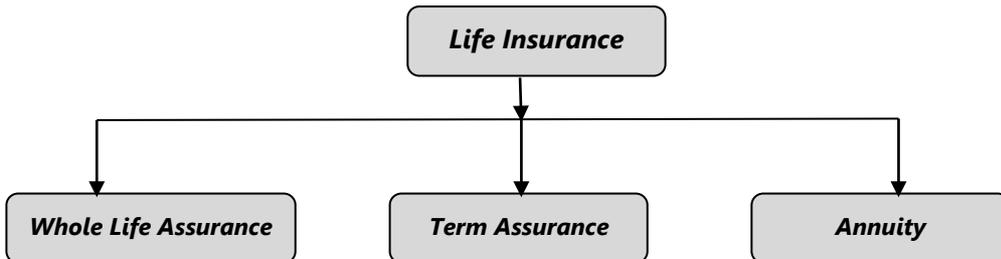
- Understand the basic concepts of Insurance
- Learn the meaning of some important terms used in insurance business, namely premium, considerations for annuities granted, claims, surrender value, bonus, paid-up policy, re-insurance and agents' balances
- Learn two main types of insurance business i.e. life insurance and general insurance and will be able to distinguish between them
- Understand the meaning and various types of fire, marine and miscellaneous policies
- Provisions of the Insurance Act requiring preparation of financial statements for the insurance business and maintenance of register or record of policies

UNIT OVERVIEW

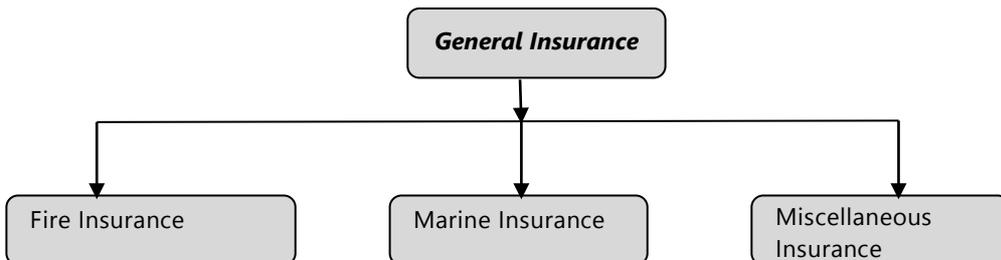
Basically, insurance is divided into two broad types viz;



Life Insurance can be further classified into 3 types:



General Insurance can be further classified into 3 types:



1.1 INTRODUCTION

Insurance is a contract in which one party namely the Insurance Company called "Insurer" undertakes to indemnify specified losses suffered by the other party called "Insured" for a special consideration called "Premium". The term of the Insurance contract is called "Insurance Policy".

Some Important terms used in Insurance Business: -

- 1. Insurance Policy:** It is the document issued by the insurance company containing terms of the insurance contract. It specifies the losses that are covered by the Policies and also the maximum amount that can be paid out in the event of a loss/death. This is called Policy Amount.
- 2. Premium:** The payment made by the insured to the Insurance Company in consideration for undertaking to indemnify specified losses suffered by the Insured by way of the contract of Insurance. The premium is generally paid annually. In some cases it may be paid at shorter intervals. A point to be noted is the premium amount has to be paid "front end" i.e. before the commencement of the insurance cover/policy.
- 3. Claims:** A claim occurs when a policy fall due for payment. In Life Insurance it arises on death or on maturity of policy. In case of General Insurance, the claim arises only when the loss occurs. While calculating the claim outstanding at the end, the claim intimated as well as the claim intimated and accepted both are considered. The adjustment entry required for this will be as follows:

Claims account Dr.

To Claims intimated and accepted but not paid account

To Claims intimated but not accepted and paid account

At the commencement of the next period a reverse entry is passed, so that when these claims intimated are paid, they may not influence the claims account of next year. However, if company rejects any claim, such amount should be transferred to the insurance fund account and not to the claims account.

Illustration 1

From the following, you are required to calculate the loss on account of claim to be shown in the revenue account for the year ending 31st December, 20X3:

<i>Claim intimated in the year</i>	<i>Claim admitted in the year</i>	<i>Claim paid in the year</i>	<i>₹</i>
20X2	20X2	20X3	15,000
20X3	20X3	20X4	10,000
20X1	20X2	20X2	5,000
20X1	20X2	20X3	12,000
20X3	20X4	20X4	8,000
20X3	20X3	20X3	1,02,000

Claim on account of Re-insurance was ₹ 25,000.

Solution

	₹
Total claim paid in 20X3 : ₹ (1,02,000 + 12,000 + 15,000)	1,29,000
Less: Outstanding in the beginning, i.e., intimated in 20X2 or earlier	
whether accepted in 20X2 accepted in 20X3 (₹ 15,000+ ₹ 12,000)	<u>(27,000)</u>
	1,02,000
Add: Outstanding at the end, i.e., intimated in 20X3 whether accepted in	
20X3 or in 20X4 ₹ (10,000 + 8,000)	<u>18,000</u>
	1,20,000
Less: Re-insurance claim	<u>(25,000)</u>
Claims to be shown in revenue account	<u>95,000</u>

4. Surrender Value: When the policy holder wishes to realise the amount of policy before the expiry of the full period of the policy, he surrenders his right under the policy and is paid an amount calculated by a fixed formula.

5. Commission: Generally, Insurance Companies get business through agents; these agents receive commission on the basis of the amount of premium they generate for the Insurance Company. Commission paid to Agents is shown as a debit (expense) in the Revenue Accounts.

6. Bonus (applicable only to Life Insurance): A life insurance policy may be "with profit" or "without profits". The holder of a "without profits" policy is entitled to receive on maturity only the amount specified in the policy; but on a "with profits" policy he is entitled to receive in addition, the amount of bonuses declared on each valuation. On each valuation, the amount standing to the credit of Life Fund which is in excess over net liability, as determined by the actuary, is distributed among the shareholders and the policyholders. The share of the policyholders is paid to them as bonus, either in cash on declaration or by reduction of future premiums, or on maturity of the policy.

7. Reversionary Bonus- Until the bonus is paid, it does not figure in the Revenue Account and is not payable in cash immediately but is to be payable at the time of the claim; it is described as Reversionary Bonus. The amount of Reversionary Bonus is included in claims.

8. Interim Bonus: It is a bonus paid to a policyholder for a period for which valuation is not complete and, therefore, the exact profit or bonus has not been determined.

9. Reinsurance: If Insurance Company does not wish to bear the whole of risk of a policy, then it will reinsure a part of risk with some other insurer. In such a case the insurer is said to have ceded (given) a part of its business to other insurer .i.e. the risk of the insurance is being underwritten by another Insurance Company.

In other words, in Re-Insurance business transaction is defined as an agreement between the Ceding Company and the Reinsurer, where the former agrees to cede (give) and the later agrees to accept certain specified share of risk in return for a share of the premium. In such a case, on a claim arising, the claim will be shared between the two companies in the proportion they had agreed to underwrite the risk.

10. Ceding Company: An insurance company that shifts part or all of a risk it has assumed to another insurance company. The Ceding company shares the premium amount it has received to cover the risk, with the second insurance company called the Reinsurer. In return, the Reinsurer company pays commission to the Ceding company for getting the business.

11. Commission on re-insurance ceded/ accepted: Insurance companies get business through its agents. Such agents receive commission on the basis of the amount of business they generate for the company. When company gets re-insurance business it has to pay commission to the Ceding company also. This commission paid by the reinsurance company is called 'commission on re-insurance accepted' and is shown as an expense in the revenue account of the re insurance company.

For the ceding company, when it passes on a part of the business to the reinsurance company then the Ceding company gets its commission from the re-insurance company. This commission is called 'commission on re-insurance ceded'. It is a gain to the company surrendering the business. It appears on the credit side of revenue account.

Other Terms Used in Insurance Business

1. Paid Up Policy (Applicable only to Life Insurance): If an insured is unable to continue to paying premiums on his life policy, he may discontinue the payment and convert the policy into a "Paid-up" policy. The insured amount in that case will be reduced to a figure ascertained according to the following formula:

$$\text{Paid-up value} = \frac{\text{No. of premium paid} \times \text{Sum assured}}{\text{Total No. of premium payable}}$$

Other conditions of the policy, however, will remain unchanged.

2. Annuity: It is a contract that provides an income for a specific period of time to say for a number of years or for life. The person receiving the payment is called an annuitant. Annuity payments are usually made monthly but can be quarterly, semi-annually, or annually.

3. Catastrophic Loss: A loss (or related losses) which is unbearable i.e. it causes severe consequences such as bankruptcy to a family, organisation, or insurer.

4. Bonus in Reduction of Premium: In all the cases of general insurance the policy is always taken for one year and it is to be renewed after the expiry of the policy. Whether the policy is renewed with the same company, or a fresh policy is taken with some other company, it is a standing practice that the company usually grants a reduction in premium at the prescribed rate if the insured has not made any claim. This rate of reduction increases every year for usually three years if the insured does not make any claim continuously year after year.

- *The journal entry is :*

Bonus in reduction of premium account Dr.

To Premium account

1.1.1 Principles of Insurance

There are several principles governing insurance business, the important of which are discussed below.

(a) Principle of indemnity: Insurance is a contract of indemnity. The insurer is called indemnifier and the insured is the indemnified. In a contract of indemnity, only those who suffer loss are compensated to the extent of actual loss suffered by them. One cannot make profit by insuring his risks.

(b) Insurable interest: Everyone cannot enter into contracts of insurance. For example, A cannot insure the life of B who is a total stranger. But if B happens to be his wife or his debtor or business manager, A has **insurable interest**, i.e., vested interest and, therefore, he can insure the life of B. For every type of policy insurable interest is insisted upon. In the absence of such interest the contract will amount to a wagering contract.

(c) Principle of uberrimae fidei: Under ordinary law of contract there is no positive duty to tell the whole truth in relation to the subject-matter of the contract. There is only the negative obligation to tell nothing but the truth. In a

contract of insurance, however there is an implied condition that each party must disclose every material fact known to him. This is because all contracts of insurance are contracts of *uberrima fidei*, i.e., contracts of utmost good faith. This is because the assessment of the risk and the determination of the premium by the insurer depend on the full and frank disclosure of all material facts in the proposal form.

1.2 VARIOUS TYPES OF INSURANCE

Basically, insurance is divided into two broad types viz; life Insurance and General insurance.

1.2.1 Life insurance policy

It covers the "life-risk" of the insured person. In case of death, the nominee will get the Insurance Policy amount. In life insurance the amount is payable on the happening of an event which is bound to occur, i.e., death. So this form of Insurance is also described as "Assurance".

However, the life insurance policy also provides for payment of the policy value at maturity or by instalments and an agreed bonus. ***This payment may either be in lumpsum on maturity of the policy or may be paid in instalments called annuity.***

The uses of the terms "insurance" and "assurance" are sometimes confused. "Insurance" refers to providing cover for an event that might happen (fire, theft, flood, etc.), while "Assurance" is the provision of cover for an event that is certain to happen like death and so Life insurance is actually Life Assurance.

Life Insurance can be further classified into 3 types: Whole Life Assurance; Term Assurance and Annuity.

- (a) **Whole Life Assurance:** In whole life assurance, policy amount is paid only on the death of Insured.
- (b) **Term Assurance:** Here the policy amount is paid in "lump-sum" on maturity of the term of the Life Insurance Policy (say 20 years).
- (c) **Annuity:** On maturity of the policy, instead of a one shot "lump-sum" payment the policy amount is disbursed in instalments, generally monthly.

1.2.2 General insurance

It means insurance other than life insurance.

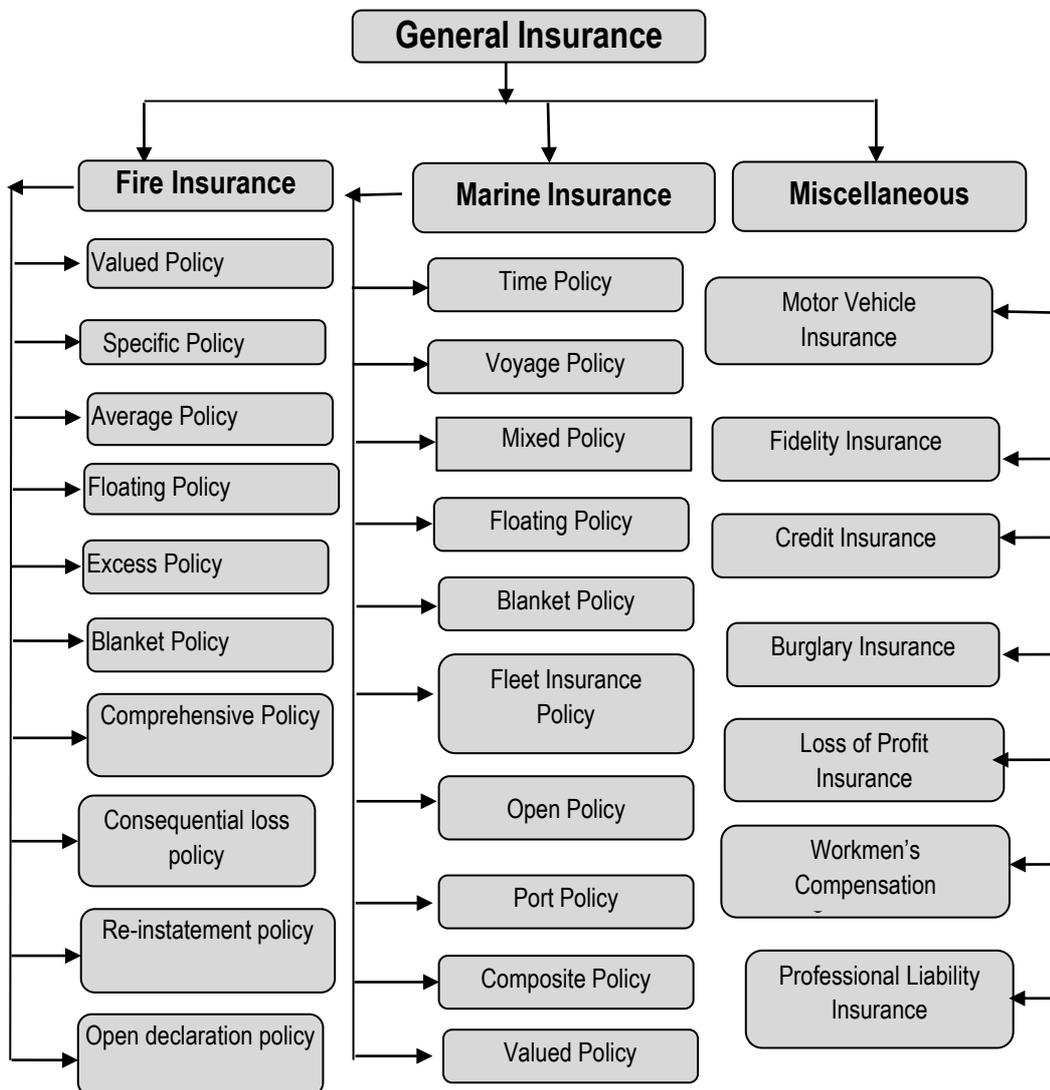
Section 2(6B) of the Insurance Act defines 'General Insurance Business' as fire, marine or miscellaneous insurance business whether carried on singly or in combination with one or more of them.

Some common types of **miscellaneous insurance** in India are: exchange risk insurance, motor vehicle insurance, credit insurance, burglary insurance, workmen's compensation insurance, professional liability insurance, cash in transit insurance, fidelity insurance, etc.

1.3 VARIOUS TYPES OF GENERAL INSURANCE

General Insurance is broadly classified into three major categories:

Fire Insurance; Marine Insurance; Miscellaneous Insurance



In general insurance, the policy is taken for one year at a time and can be renewed yearly or a fresh policy can be taken with some other insurance company.

The three types of General Insurance:

1.3.1 Fire Insurance

A fire insurance contract may be defined as an **agreement whereby one party, for a consideration, undertakes to indemnify the other party upto an agreed amount against financial loss of goods or property which the latter may suffer because of fire.** Fire insurance thus covers the risk of loss of property by accidental and non-intentional fire.

Types of Fire Policies

- (i) ***Valued policy*** - A policy in which the value of the property is ascertained and/or agreed upon which the insurer undertakes to pay in the event of destruction of goods/property by fire is known as *valued policy*. This type of policy is not very common these days.
- (ii) ***Specific policy*** - It is a policy which insures a risk for a specific amount. In case of any loss under this policy, the insurer pays whole loss provided it is not more than the sum specified in the policy. Thus, the value of the goods/property is not considered for this purpose.
- (iii) ***Average policy*** - An average policy contains the 'average clause' which lays down that if the property is under-insured, *i.e.* insured for a sum smaller than the value of the property, the insurer will bear only that proportion of the actual loss which the sum assured bears to the actual value of the property at the time of loss.
- (iv) ***Floating policy*** - It is the policy which covers several types of goods lying at different locations under one amount and for one premium. The premium normally charged under this policy is the average of the premium that would have been paid if each lot of the goods had been insured under specific policies for specific sums.
- (v) ***Excess policy*** - Where the stocks of the insured fluctuate he may take out a policy for the amount below which his stocks normally do not fall and another policy to cover the maximum amount of stocks which may be reached at times. The former type of policy is known as the *First Loss Policy* and the latter as the *Excess Policy*.

- (vi) **Blanket policy** - A blanket policy is that which covers all assets - fixed as well as current - under one policy.
- (vii) **Comprehensive policy** - A policy which covers risks such as fire, flood, riots, strikes, burglary etc. upto a certain specified amount is known as the comprehensive policy.
- (viii) **Consequential loss policy** - The objective of this policy is to indemnify the insured against the loss or profit caused by any interruption of business due to fire. It is also known as *Loss of Profit Policy*.
- (ix) **Re-instatement policy** - It is a policy under which the insurer pays the amount which is sufficient to re-instate assets or property destroyed.
- (x) **Open declaration policy** - It is a policy whereby the insured makes a deposit with the insurer and declares the value of the subject matter in respect of which risk is covered.

Such policies are normally taken where the value of stocks, etc. fluctuates considerably.

1.3.2 Marine Insurance

Marine insurance is perhaps the oldest type of insurance. Under a contract of marine insurance, **the insurance company or the underwriter agrees to indemnify the owner of a ship or cargo against risks which are incidental to marine adventure such as sinking or burning of the ship and its contents, stranding of the ship, collision of ship, Jettison, i.e.,** throwing overboard the cargo into the sea to save the ship from sinking or some other imminent danger, *barratry, i.e.,* wrongful act of the captain of the ship in destroying or stealing the vessel or cargo causing loss to owners.

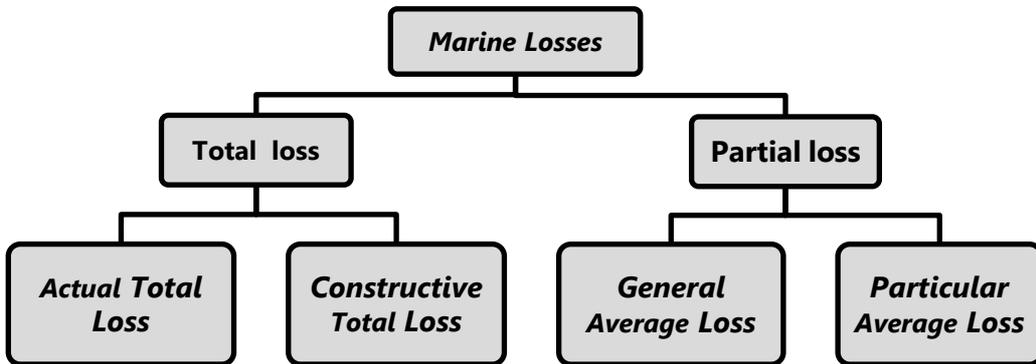
Types of Marine Insurance - The common types of marine insurance are as follows:

- (i) **Cargo insurance** - This type of marine insurance covers risks to the cargo on the ship. The cargo on the ship is exposed to risks arising from an act of God, enemies, fire etc.
- (ii) **Hull insurance** - The ship is also exposed to the perils (danger) described in (i) above. Therefore, the owner of the ship may effect 'hull' insurance to cover such perils.
- (iii) **Freight insurance** - Where the owner of goods promises or undertakes to pay the freight when the cargo is safely delivered at the port of destination and the cargo is destroyed on the way, the shipping company would lose the

freight. The shipping company can cover this risk by taking out a freight insurance policy.

The **persons who insure cargo, hull or freight are known as underwriters** because they write their name and sign at the foot of the policy.

Types of Marine Losses - Marine losses may be broadly of two types –



- (i) **Total Loss** : When the subject matter of insurance, *i.e.*, cargo, ship, freight etc. is totally lost, it is known as a 'total loss'. Total loss is also of two types:
 - (a) **Actual Total Loss** - When the subject-matter of insurance is absolutely destroyed or totally lost to the insured, it is known as actual total loss.
 - (b) **Constructive Total Loss** - When the subject matter is not actually totally lost but is lost for all practical purposes *e.g.*, where the ship or cargo is reasonably abandoned and taken as lost or expenses to be incurred for saving the cargo or the ship are expected to be more than the value thereof, it is known as constructive total loss.
- (ii) **Partial Loss** : When only a part of the subject matter is lost, it is known as partial loss. This loss may also be of two types as discussed below :
 - (a) **General Average Loss** - Such a loss is caused by extraordinary voluntary sacrifice made or expenditure incurred with the objective of protecting the interests of all owners in a voyage. An example of this type of loss is when the ship has run aground and part of the cargo is to be jettisoned to lighten the ship to save it as well as the cargo from total loss.
 - (b) **Particular Average Loss** - It is a partial loss of the subject matter of insurance caused by a peril against which it is insured but which is not a general average loss.

Types of Marine Insurance Policies - Generally a standard form for all policies is used for all marine insurance policies to cover various types of risks. However,

differing needs of the insured have led to the evolution of a variety of marine insurance policies, the main among which are:

- (i) **Time policy** - It is that policy which covers the risk of the subject matter for a specified period of time. It is generally used for hull insurance though it can be taken out also for cargo.
- (ii) **Voyage policy** - This is a policy whereby the subject matter in transit is insured from one place to another. It is generally carried out for cargo which is exposed to marine risks in transit.
- (iii) **Mixed policy** - This is also known as *time and voyage policy* as under this the subject matter on a particular voyage is insured for a specified period of time.
- (iv) **Floating policy** - This policy is taken out by cargo owners who make regular shipments of cargo to insure the shipments expected to be shipped for a certain time by one policy. At the time the cargo is shipped, the insured declares the value of the shipment and the total value of the policy is reduced by that amount.
- (v) **Blanket policy** - This policy is taken for a specified amount, the premium in respect of which is paid for the entire policy at the beginning itself and is adjusted at the end of the specified period for the value of risks covered during this period.
- (vi) **Fleet insurance policy** - This policy insures the whole fleet of ships.
- (vii) **Open policy** - This type of policy is taken out without specifying the value where at the time of insurance, the insured is not aware of the value of the subject matter to be insured, which is ascertained and declared to the insurer later. The insurance cover is subject to the limit of the sum assured.
- (viii) **Port policy** - This policy covers the ship when it is docked/stationed at a port.
- (ix) **Composite policy** - It is a policy underwritten by more than one underwriter. The liability of each underwriter is however distinct and separate.
- (x) **Valued policy** - Under this policy, the value of the subject matter is agreed between the underwriters and the insured at the time of taking the policy and is specified therein.

Clauses in a Marine Policy:

A marine policy may cover or exclude various types of risks. In view of this some special clauses may be inserted in the policy. Some of the important clauses are discussed below:

- (i) **Lost or Not Lost Clause** - When this clause is inserted in the policy, the goods are insured irrespective of whether they are already lost or not lost before the policy is taken out. In other words, it covers loss of goods occurring between shipment of goods and the issuance of policy.
- (ii) **Waiver Clause** - When this clause is included in a marine policy no act of the insurer or the insured in saving, maintaining and preserving the cargo or the hull will be considered as a "waiver", i.e., in case the insured takes steps under Sue, Labour and Travel clause after the notice of abandonment is given by him to the insurer but is not accepted by the insurer, it will not amount that the notice of abandonment is waived. Thus, if the insurer takes any such steps, it cannot be taken to mean as an acceptance of the notice of abandonment.
- (iii) **Permission to Touch and Stay Clause** - As per this clause, the ship is permitted to touch and stay at the ports mentioned in the policy in the order specified therein. In case nothing is specified, the ship must touch and stay at ports which are normally touched in the particular trade. Any deviation from the route specified is permitted in an emergency to save the ship and the lives of the passengers.
- (iv) **Running Down Clause (RDC)** - This clause enables the insured to claim the loss caused by collision with another ship.
- (v) **Free of Capture and Seizure Clause (FCS)** - This clause is included in the policy to clarify that the underwriters will not be liable for any loss caused by ship being captured or seized in a war or warlike situation.
- (vi) **Continuation Clause** - This clause may be included in a time policy whereby the ship will be covered until the end of the voyage or for not more than 30 days thereafter where the ship is still at sea at the time of expiry of the policy. A monthly *pro rata* premium is required to be deposited for this purpose.
- (vii) **Excepted Perils Clause** - This clause specifies the risks not covered by the insurance policy.
- (viii) **Free of Particular Average (FPA) and Free of All Averages (FAA) Clauses** - As the names suggest, the FPA clause exempts the underwriter from particular average and all averages, i.e., both general and particular average liabilities (discussed hereinafter).
- (ix) **Insurance Clause** - This clause covers, among others, the losses caused by the negligence of master, crew etc. or by explosives or by other defects in machinery of the ship.

- (x) **Jettison Clause** - This clause covers the loss caused by jettisoning of goods, i.e., throwing overboard goods to reduce the weight of the ship and prevent capture by the enemy.
- (xi) **Barratry** - This clause covers all losses caused by willful misconduct or defaults of the master and crew of the ship.

1.3.3 Miscellaneous Insurance Policies

In addition to the types of general insurance business discussed above, there are a number of insurance policies which cover various other types of risks, the important ones of which are discussed hereinafter.

Motor Vehicle Insurance - Motor Vehicle insurance policies are normally taken out to cover two types of risk—(i) the risk of damage by an accident or loss by theft, and (ii) risk of liability arising from an injury or death of any person in an accident caused by a vehicle, commonly known as Third Party Insurance. The owner of a vehicle is compulsorily required to get third party insurance under the Indian Motor Vehicles Act whereas the other types of insurance are voluntary.

Fidelity Insurance - This type of insurance protects an employer against the frauds, defalcations etc., on the part of his employees where, as part of their employment obligations, such employees are required to handle cash, goods or other valuables of the employer.

Credit Insurance - Credit insurance is taken out to protect the insured against the losses caused by bad debts due to insolvency of the debtors or otherwise.

Burglary Insurance - Burglary insurance policy is issued whereby the insurer undertakes to indemnify the insured against losses from burglary, i.e., the removal of movable goods by theft or burglary.

Loss of Profit Insurance - Loss of profits insurance is often accompanied by fire insurance and it covers the risk of loss of profits caused by fire, including fixed costs which are continued to be incurred till the business starts functioning at its normal level.

Workmen's Compensation Insurance - This type of insurance covers the risk of liability arising on account of payment of compensation where a worker suffers injury or dies in an accident in the course of his employment.

Professional Liability Insurance - Professional liability insurance protects the professionals, such as doctors, lawyers and accountants, against the risk of liabilities arising towards clients or third parties in connection with their work. This may also include legal expenses incurred in defending law suits.

The scope of miscellaneous insurance business is very wide and encompasses almost all commercial activity.

Important point to be remembered

- Only in general insurance policy the insured gets compensation only in case of loss sustained by him due to reasons specified in the policy.

1.4 DISTINCTION BETWEEN LIFE INSURANCE AND OTHER FORMS OF INSURANCE

		Life Insurance	Other Insurance
1.	Timing of Payment of Claim	Insurable amount is payable either on the happening of the event (death) or at the maturity	Reimbursement of loss or liability incurred will be paid at the happening of the uncertain event only.
2.	Value of Policy	Insurance can be done for any value depending upon the premiums the insured is willing to pay.	The sum payable under it is limited to the amount of loss actually suffered or the liability incurred, notwithstanding the amount of policy.
3.	Duration of Contract	-These are long term contracts running over the number of years.	These are only for one year though renewable after year.
4.	Assurance	Life insurance is known also by another term 'assurance' since the insured gets an assured sum.	Other policies are known as insurance.
5.	Determination of Liability	Actuaries periodically estimate the liability under existing policies. On that basis a valuation balance sheet is prepared to determine the profit.	A portion of the premium is carried forward as a provision for unexpired liability and the balance net of claims and expenses is taken as profit or loss.

1.5 SOME RELEVANT PROVISIONS OF THE INSURANCE ACT, 1938 [UPDATED AS PER THE INSURANCE (AMENDMENT) ACT 2015]

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 management of all the 107 companies were taken over by the Government and accordingly the General Insurance Corporation (GIC) was formed as a government company in November 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 Insurances Company do all classes of direct business of general insurance except aviation which is done by the GIC.

The Insurance Act, 1938 and the rules framed there under have an important bearing on the preparation of accounts of insurance companies. Some of the provisions have become irrelevant after the nationalisation of general insurance. Some provisions have been amended by IRDA Act, 1999 and Insurance (Amendment) Act 2015.

(1) Forms for final accounts [Section 11(1)]. Every insurer, on or after the date of the commencement of the Insurance Laws (Amendment) Act, 2015, in respect of insurance business transacted by him and in respect of his shareholders' funds, should, at the expiration of each financial year, prepare with reference to that year, balance sheet, a profit and loss account, a separate account of receipts and payments, a revenue account in accordance with the regulations as may be specified.

(2) Audit [Section 12]: The balance sheet, profit and loss account, revenue account and profit and loss appropriation account of every insurer, in respect of all insurance business transacted by him, should, unless they are subject to audit under the Companies Act, 2013, be audited annually by an auditor, and the

auditor should in the audit of all such accounts have the powers of, exercise the functions vested in, and discharge the duties and be subject to the liabilities and penalties imposed on, auditors of companies by Section 147 of the Companies Act, 2013.

(3) Register of policies [Section 14(1)]: Every insurer, in respect of all business transacted by him, should maintain— (a) a record of policies, in which should be entered, in respect of every policy issued by the insurer, the name and address of the policyholder, the date when the policy was effected and a record of any transfer, assignment or nomination of which the insurer has notice; (b) a record of claims, every claim made together with the date of the claim, the name and address of the claimant and the date on which the claim was discharged, or, in the case of a claim which is rejected, the date of rejection and the grounds thereof; and (c) a record of policies and claims in accordance with clauses (a) and (b) may be maintained in any such form, including electronic mode, as may be specified by the regulations made under this Act.

(5) Approved investments (Section 27B(1)): A company carrying on general insurance business must invest its funds only in approved securities listed in this section.

(6) Payment of commission to authorised agents (Section 40(1)): As per the Insurance (Amendment) Act 2015, no person should, pay or contract to pay any remuneration or reward, whether by way of commission or otherwise for soliciting or procuring insurance business in India to any person except an insurance agent or an intermediary or insurance intermediary in such manner as may be specified by the regulations.

(7) Limit on expenditure (Sections 40B and 40C):

As per the Insurance (Amendment) Act 2015 No insurer should, in respect of insurance business transacted by him in India, spend as expenses of management in any financial year any amount exceeding the amount as may be specified by the regulations made under this Act and every insurer transacting insurance business in India should furnish to the Authority, the details of expenses of management in such manner and form as may be specified by the regulations made under this Act."

(8) Sufficiency of assets [Section 64VA(1)]: Every insurer and re-insurer should at all times maintain an excess of value of assets over the amount of liabilities of, not less than fifty per cent. of the amount of minimum capital as stated under section 6 and arrived at in the manner specified by the regulations.

1.6 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY ACT, 1999 AND INSURANCE (AMENDMENT) ACT 2015

The Insurance Regulatory and Development Authority Act, 1999 is an act to provide 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 and further to amend the Insurance Act, 1938 the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972 to end the monopoly of the Life Insurance Corporation of India (for the insurance business) and General Insurance Corporation and its subsidiaries (for general insurance business).

The Act was published in the Gazette of India on 29th Dec., 1999 and extends to the whole of India. Words and expressions used and not defined in this Act but defined in the Insurance Act, 1938 or the Life Insurance Corporation Act, 1956 or the General Insurance Business (Nationalisation) Act, 1972 should have the meanings respectively assigned to them in those Acts.

Applicable to	Schedule A Life Insurance Business	Schedule B General Insurance Business
Premium recognised is	When due	<ul style="list-style-type: none"> • Over contract period or period of risk • Unearned premium is a Current Liability and Reserve have to be created for it. • Premium in advance is also a Current Liability
Premium deficiency is recognised if:	-	The sum of expected claim costs, related expenses and maintenance costs exceeds related reserve for unexpired risks.
Acquisition Costs = Expenses related to acquisition of new	Expensed in the year in which they are incurred	Expensed in the year in which they are incurred

and renewal insurance contracts		
Claims	Policy Benefit Amount + Claim settlement cost	Claims for losses incurred + Settlement cost + Claims incurred but not Reported (IBNR) + Claims incurred but not enough reported (IBNER) treated in Outstanding claims.
Actuarial Valuation	The estimation of liability against life policies should be determined by the appointed actuary of the insurer pursuant to his annual investigation of the life insurance business. Actuarial assumptions are to be disclosed by way of notes to the account.	Actuarial valuation is required for contracts more than 4 years. Actuarial assumptions should be suitably disclosed by way of notes to the account.
Investment a) Real Estate Investment Properties	<ul style="list-style-type: none"> Valued at historical cost Revaluation in 3 years; change in carrying amount transferred to Revaluation Reserve. Assessment of impairment at each balance sheet date- Impairment loss is transferred to Profit and Loss Account Impairment losses on revalued asset is transferred to revaluation Account 	<ul style="list-style-type: none"> Valued at historical cost (-) Accumulated Depreciation (-) impairment loss Assessment of impairment at each balance sheet date- Impairment loss is transferred to Profit and Loss Account. Revaluation is not permitted

b) Debt Security including Govt. Securities and redeemable Preference Shares	Considered as held to maturity and measured at historical cost subject to amortisation.	Considered as held to maturity and measured at historical cost subject to amortisation.
c) Equity Security and derivative Instruments traded activity (Unit sold/purchased more 10,000 units per annum)	<ul style="list-style-type: none"> • Measured at Fair Market Value (FMV) • FMV = Lowest of last quoted closing prices on the stock exchange • Unrealised gain / losses due to changes in FMV is taken to Fair Value Change A/c. • The actual profits/loss on the sale of investment and Fair value change account is transferred to Revenue/ Profit and Loss. Till then FVC A/c is not available to Shareholders for dividend. 	<ul style="list-style-type: none"> • Measured at FMV • FMV = Lowest of last quoted closing prices on stock exchange • Unrealised gains/loss due to change in FMV is taken to Fair Value Change Account. • The actual Profit or Loss on the sale of investment and FVC account is transferred to Profit and Loss Account. • Till then FVC Account is not available for dividend •
d) Unlisted and other non-actively traded equity shares and derivatives Instruments. (Non-active if trading Vol. does not exceed 10,000 units of that securities)	<ul style="list-style-type: none"> • Kept at historical cost • Provision should be made for diminution in value of such investments • Provision for diminution it can be reversed in case of increase but the carrying amount cannot be more than historical cost. 	<ul style="list-style-type: none"> • Kept at Historical cost • Provision should be made for diminution in value of such investments • Provision for diminution it can be reversed in case of increase but the carrying amount cannot be more than historical cost.
Loans	<ul style="list-style-type: none"> • At historical cost subject to impairment provision. 	<ul style="list-style-type: none"> • At historical cost subject to impairment provision.

Catastrophe Reserve	-	Catastrophe reserve should be created in accordance with norms, if any, prescribed by the Authority. Investment of funds out of catastrophe reserve should be made in accordance with prescription of the Authority.
Linked Business	- A separate set of financial statements, for each segregated fund of the linked businesses, should be annexed. Segregated funds represent funds maintained in accounts to meet specific investment objectives of policyholders who bear the investment risk. Investment income/ gains and losses generally accrue directly to the policyholders. The assets of each account are segregated and are not subject to claims that arise out of any other business of the insurer.	-

Important amendments made to the earlier Act by the IRDA Act, 1999

(1) It is mandatory for every Insurer on or after the commencement of this Act, to prepare a balance sheet, a profit and loss account, a separate receipts and payments account, a revenue account in respect of insurance business transacted by him and in respect of his shareholders funds. The accounts are to be prepared for every financial year instead of the calendar year. The accounting year has already been changed to financial year when insurance companies prepared the accounts for 15 months ending with the financial year 1988-89, in response to

Government directive. The directive might have become necessary because of the change in the previous year effected by Income Tax Act. The Act was amended requiring previous year to be the financial year.

(2) Every insurer must keep separate accounts relating to funds of shareholders and policyholders.

(3) Insurers are prohibited from investing either directly or indirectly their funds outside India.

(4) The Regulatory Authority has the power to direct the insurers to invest funds in infra structure and social sectors subject to certain conditions. The authority in general has the power to direct the time, manner and other conditions of investment with a view to protect the interests of policyholders. The amendment raises commission on fire and marine policies from the previous 10% to 15%.

(6) There is a necessity for insurers to keep a required solvency margin. The margin refers to the excess of assets over liabilities. If an insurer does not maintain such a margin, he has to submit a financial plan indicating a plan to correct the deficiency. If these requirements are not met to the satisfaction of the Authority, the insurer may be deemed to be insolvent and the company may be wound up by the court.

(7) Every insurer must submit to the Authority a prescribed return certified by an actuary in the case of life business and certified by an auditor in the case of general insurance business to show that the required solvency margin has been maintained.

(8) Every insurer carrying on general insurance business is required to create a 'Catastrophe Reserve' to meet the future potential liability against the insurance policies in force. This reserve is not created for any specific or known purpose. Creation of this reserve should be in accordance with the regulations issued by the Authority. So far the Authority has not issued any regulation in this regard.

It may be noted that the Union Cabinet had passed the Insurance Laws (Amendment) Bill, 2015 in March, 2015. The passage of the Bill thus paved the way for major reform related amendments in the Insurance Act, 1938, the General Insurance Business (Nationalisation) Act, 1972 and the Insurance Regulatory and Development Authority (IRDA) Act, 1999. The Insurance Laws (Amendment) Act 2015 so enacted, seamlessly replaces the Insurance Laws (Amendment) Ordinance, 2014, which came into force on 26th December 2014.

The passage of this Amendment Act paved the way for major reform related amendments in the following acts : –

- ◆ Insurance Act, 1938
- ◆ The General Insurance Business (Nationalisation) Act, 1972
- ◆ The Insurance Regulatory and Development Authority (IRDA) Act, 1999.

The amendment Act will remove archaic and redundant provisions in the legislations and incorporates certain provisions to provide Insurance Regulatory and Development Authority of India (IRDAI) with the flexibility to discharge its functions more effectively and efficiently. It also provides for enhancement of the foreign investment cap in an Indian Insurance Company from 26% to an explicitly composite limit of 49% with the safeguard of Indian ownership and control.

As per the Insurance (Amendment) Act 2015, The General Insurance Corporation and the insurance companies specified in section 10A of the Insurance Act, 1938 states that they may, raise their capital for increasing their business in rural and social sectors, to meet solvency margin and such other purposes, as the Central Government may empower in this behalf: Provided that the shareholding of the Central Government should not be less than fifty one per cent. at any time.". This Amendment Act will entrust responsibility of appointing insurance agents to insurers and provides for IRDAI to regulate their eligibility, qualifications and other aspects. It enables agents to work more broadly across companies in various business categories; with the safeguard that conflict of interest would not be allowed by IRDAI through suitable regulations.

IRDAI is empowered to regulate key aspects of Insurance Company operations in areas like solvency, investments, expenses and commissions and to formulate regulations for payment of commission and control of management expenses.

It empowers the Authority to regulate the functions, code of conduct, etc., of surveyors and loss assessors. It also expands the scope of insurance intermediaries to include insurance brokers, re- insurance brokers, insurance consultants, corporate agents, third party administrators, surveyors and loss assessors and such other entities, as may be notified by the Authority from time to time.

Further, properties in India can now be insured with a foreign insurer with prior permission of IRDAI; which was earlier to be done with the approval of the Central Government.

References:

Study on Audit of companies carrying on General Insurance Business published by the Institute of Chartered Accountants of India; Insurance Act, 1938; General Insurance (Nationalisation) Act, 1972; Life Insurance Corporation Act, 1956; and Insurance Regulatory and Development Authority Act, 1999, Insurance Regulatory and Development Authority Regulations, 2002; INSURANCE (AMENDMENT) ACT 2015 .

SUMMARY

- **Claims:** it refers to the amount payable by insurer to the insured when policy becomes due or the mis-happening occurs.
Claim = Claim intimated + Survey fees + Medical expenses – Claims received on re-insurance.
- **Premium:** it refers to the consideration received by the insurance company to undertake the risk of the loss. It is always net of premium paid on reinsurance.
- **Annuity (LIC):** it is fixed annual payment made regularly till insured lives. This is in consideration of lump-sum money paid by him in the beginning of the policy.
- **Bonus:** the profit of LIC is distributed among the shareholders and policy holders. The policy holders get 95% of the profit of LIC by way of bonus. The bonus may be of following types:
 - **Cash Bonus:** paid on declaration of bonus in cash.
 - **Revisionary Bonus:** it is paid with the policy maturity instead of cash amount now. This bonus is added in the amount of claims.
 - **Bonus in reduction of Premium:** Bonus is not paid in cash but adjusted against the future premiums.
 - **Interim Bonus:** it refers to bonus paid on the maturity of policy in the year for which the profit has not yet been determined. Such a bonus is included in claims.
- **Reinsurance** : if an insurer is not willing to bear the whole of the risk, it reinsure itself. Some risk retains with some other insurer.

TEST YOUR KNOWLEDGE

Theoretical Questions

Question 1

Explain in short, the following principles and term of insurance business:

- (i) Principle of Indemnity;
- (ii) Insurable interest;
- (iii) Principle of "UBERRIMAE FIDEI".
- (iv) Catastrophic Loss

Answer 1

- (i) Principle of indemnity: Insurance is a contract of indemnity. The insurer is called indemnifier and the insured is the indemnified. In a contract of indemnity, only those who suffer loss are compensated to the extent of actual loss suffered by them. One cannot make profit by insuring his risks.
- (ii) Insurable interest: Everyone cannot enter into contracts of insurance. For example, A cannot insure the life of B who is a total stranger. But if B happens to be his wife or his debtor or business manager, A has insurable interest i.e. vested interest and therefore he can insure the life of B. For every type of policy insurable interest is insisted upon. In the absence of such interest the contract will amount to a wagering contract.
- (iii) Principle of UBERRIMAE FIDEI: Under ordinary law of contract there is no positive duty to tell the whole truth in relation to the subject-matter of the contract. There is only the negative obligation to tell nothing but the truth. In a contract of insurance, however there is an implied condition that each party must disclose every material fact known to him. All contracts of insurance are contracts of uberrima fidei, i.e., contracts of utmost good faith. This is because the assessment of the risk and the determination of the premium by the insurer depend on the full and frank disclosure of all material facts in the proposal form.
- (iv) Catastrophic Loss: A loss (or related losses) which is unbearable i.e. it causes severe consequences such as bankruptcy to a family, organisation, or insurer.