

Accounting of Life Insurance Companies

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The Accounting function of the life insurance companies is quite different from that of other companies. In the present scenario finalisation of accounts of an insurance company involves a lot of complexities, which are unique in nature.



In 1993, Malhotra Committee was formed to evaluate the Indian insurance industry and recommend its future direction. The Committee was set up with the objective of complementing the reforms initiated in the financial sector. In 1994, the Malhotra Committee submitted the report. Based on the recommendations of the Committee, the country has witnessed radical changes in the insurance industry, both in general and life insurance. The setting up of regulatory authority – Insurance Regulatory and Development Authority (IRDA) and the issue of new regulations followed the Committee report. The entry of new private insurers into the sector has given momentum to the competition and the growth. As of now, the total number of companies registered with IRDA is 14 in Life sector and 13 in Non-life sector.



Accounting Function

The Accounting function of the life insurance companies is quite different from that of other companies. The major reasons for this are due to:

- ☒ Ascertainment of liability in respect of insurance policies issued by the company
- ☒ The concept of Policyholders' Fund and Shareholders' Fund
- ☒ The unit linked business and the related investment valuations involved in the same and
- ☒ Segmental reporting in respect of all the funds maintained by the company.

With the given scenario, the finalisation of accounts of an insurance company involves a lot of complexities, which are unique in nature.

The Financial Statements of Insurance Company consists of:

- ✍ Revenue Account (Policyholders Account)
- ✍ Profit and Loss account (Shareholders Account)
- ✍ Balance Sheet
- ✍ Receipts and Payments account (Cash Flow Statement)
- ✍ The segmental reports relating to the funds (Revenue accounts and Balance Sheet)

The above statements are to be in conformity with the Accounting Standards issued by ICAI, to the extent applicable to the life insurance business except that:

- Cash Flow Statement needs to be prepared under Direct Method and
- Segmental Reporting shall

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apply to all insurers irrespective of listing and turnover mentioned in AS 17.

Insurance Regulatory and Development Authority (IRDA) has prescribed specified formats for the preparation of Financial Statements. These formats are in Part V of Schedule A of IRDA (Preparation of Financial Statements and Auditors Report of Insurance Companies) Regulations, 2002.

1) Revenue Account (Policyholders' Account – Technical Account)

The Revenue Account sets out all income and expenses relating to the insurance business.

Income

The income of the technical account comprises of

- Premium after adjusting reinsurance ceded and reinsurance accepted
- Income from investments which needs to be shown under different heads like:
 - ☑ Interest, Dividend and Rents
 - ☑ Profit on sale redemption of investments
 - ☑ Loss on sale redemption of investments
 - ☑ Transfer gain on revaluation of change in fair value and
 - ☑ Amortisation charge

Under the Income head, there will also be Other Income, Foreign exchange gain/Loss and other items.

The transfer of funds from

Shareholders' Fund to Policyholders' Account is shown separately in the Revenue Account.

Expenses

- Expenses include:
 1. Commission
 2. Operating Expenses
 3. Benefits paid
 4. Interim bonus paid and
 5. Change in valuation of liability against life policies in force.

Accounting Principles to be followed: -

The regulator has also issued instructions as to the Accounting Principles to be followed in the preparation of Financial Statements.

The Premium income is recognised as and when due. For linked business, it is the date when associated units are created. Acquisition costs are expensed out in the period in which they are incurred. Claim costs include the policy benefit amount and the specific claims settlement costs.

Policyholders Fund

The Policyholders Funds need to maintain adequate level of solvency at all times. Separate Funds are maintained for different types of policies like participating Fund, Pension Fund etc. The solvency level is also to be maintained for declaration of bonuses to Participating Fund and Pension Fund.

As we all know, during the initial period, company starts with Shareholders Fund. In order to meet with the above requirements of the Policyholders' Fund, the company needs to transfer funds from

Shareholders' Fund. This transfer has been allowed by IRDA during the first five years. The IRDA also specifies that no bonus can be declared by an insurance company if the company is in deficit. To tackle the situation, the transfer from Shareholders' Fund is necessary.

Such transfers from Shareholders' Fund to Policyholders' A/c is irreversible in nature and at no point of time, such amount can be recouped to the Shareholders' Fund. Transfer of such funds is shown in Revenue Account and it adds to the revenue of the Technical Account.

The same amount is treated as expenditure in Profit & Loss account (Shareholders' Account – Non Technical account).

Actuarial valuation

The estimation of liability against life policies shall be determined by the appointed actuary of the insurer based on his annual investigation of the life insurance business. The actuarial assumptions are disclosed in the Financial Statements. The valuation process plays a significant role in the determination of the surplus / deficit of the insurance company. The change in valuation of liability against life policies in force is taken to revenue as expenditure, while finding surplus or deficit.

The taxation of such surplus is being dealt with by the Income Tax Act in Section 44, Schedule 1 and Section 115 B.

2) Profit and Loss Account (Shareholders' Account – Non-Technical Account)

This Account represents all

income and expenses relating to Shareholders' Account (Those not relating to insurance business).

Income

The income comprises mainly of investment or other income created out of Shareholders' Fund.

Expenses

The major components of expenses are:

- Depreciation relating to assets held by shareholders' fund, investment expenses, Directors Fees etc.
- Transfer of funds to Policyholders' Fund and
- Preliminary Expenses written off

The profit or loss as per the Account is carried to the Balance Sheet as usual.

3) Balance Sheet

The items in the Balance Sheet of a Life Insurance Company includes, other than the normal items –

1. Shareholders' Fund
 2. Policy Holders Fund
 3. Investments related to Policyholders' Fund, Shareholders' Fund and Assets held to cover linked liabilities
- Shareholders' Fund includes share capital less preliminary expenses, reserves and surplus and fair value change account.

Policyholders' Fund consists of Policy liabilities, Fair value change relating to policy fund investments, insurance reserves, provision for linked liabilities, Funds for future appropriations, Surplus allocated to shareholders etc.

The balance in the Funds for future appropriations represents

funds, the allocation of which, either to participating policyholders or to shareholders has not been determined at the balance sheet date. Transfers to and from the fund reflect the excess or deficiency of income over expenses and appropriations in each accounting period arising in the Company's policyholder fund.

Investments of a Life Insurance Company

The Insurance Company has to follow the provisions set out in Section 27 of the Insurance Act, 1938, read with Rule 3 of the IRDA (Investment) Regulations, 2000.

Accordingly, the controlled fund of the company has to be invested in the specified securities. The assets relating to Pension business, Annuity business and Linked Life Insurance business shall not form part of Controlled Fund.

Separate norms are formulated for investing funds of Pension business and Annuity business.

The funds relating to Unit Linked Insurance business are to be invested as per the pattern of investment offered to and approved by the policyholders. However, the total investment in other than approved category of investments shall at no time exceed 25 % of the Fund.

Valuation of investments

Real Estate – Investment property

The investment property shall be valued at historical cost subject to revaluation at least once in every three years. The change in the carrying amount of the investment property shall be taken to Revaluation Reserve.

Debt securities

Debt securities, including government securities and redeemable preference shares shall be considered as "held to maturity" securities and shall be measured at historical cost, subject to amortisation.

Equity securities and Derivative instruments

Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value on the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price at national Stock Exchange or Bombay Stock exchange shall be taken.

Unrealised gains and losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head "Fair Value Change Account".

Unlisted and other than actively traded equity securities and Derivative Instruments are measured at historical cost.

Loans

Loans are measured at historical cost subject to impairment provisions.

Linked Business

The accounting principles used for valuation of investment are to be consistent with the above mentioned principles. A separate set of financial statement for each segregated fund of the linked business shall be annexed.

Investment transfer

■ **From Shareholders' Fund to Policyholders' Fund**

The IRDA circular talks about

transfer of investments from Shareholders' Fund to Policyholders' Fund. Such transfers made with the objective of meeting the deficit in Policyholders' Account should be at the cost or market value, whichever is less. In case of debt securities, it shall be at the net amortised cost.

■ Transfer between policyholders' funds

The Regulator does not allow transfers between different policyholders' funds.

■ Purchase /sale transactions between unit linked funds

These transactions are likely as part of investment management strategy to limit transactions cost and also arising out of options exercised by policyholders to shift between different unit linked funds. The sale / purchase under such circumstances would be based on the market price of the investments, which are being shifted between unit linked schemes.

During the initial years, security sale at market price shall be permitted from shareholders' assets in the approved category to meet the investment needs of policyholders' funds. Such transactions are allowed where policyholders' fund size is small ie. upto Rs. 50 crores.

4) Receipts and Payments account (Cash Flow Statement)

The cash flow statement of the insurance company needs to be worked out as per Direct Method as per the IRDA requirement. The

statement depicts the receipts and payments from various business activities. The major items are:

Operating Activities

- Receipts and Payments from policyholders
- Payments to Re insurers
- Payments to Agents, Employee expenses, investment income

Investing Activities

- Purchase and sale of investments
- Purchase of fixed assets

Financing Activities

This refers to the issue of share capital or raising of funds from other sources.

5) Segmental Reporting

As per the regulations, every insurance company has to prepare segment wise Revenue Account and Balance Sheet of the business it has done. Accordingly, the company is required to report segment results separately for Participating, Non-Participating, Pension, Annuity business and Unit Linked business (Group, Individual – Life and Individual Pension). For the purpose of working out results of such segments, company will decide on the bases on which revenue, expenses, assets and liabilities are to be allocated. The accounting policies used in the segmental reporting are to be disclosed in the Financial Disclosures.

Disclosure requirements

The IRDA Rules also specify the disclosure requirements, general instructions for preparation of financial statements, and also the contents of the Management Report.

Financial summary and Ratios

IRDA has also specified the format for Financial Statement summary for the previous financial years and the relevant ratios to be worked out. The summary and the ratios form part of the Financial Disclosures.

The prospects of Chartered Accountants vis a vis growth of Insurance industry

The opening up of the industry to private players offers a lot of opportunities to the community of Chartered Accountants. As per the IRDA regulations, the Life Insurance Companies should have joint auditors and IRDA maintains panel of auditors for the insurance companies.

There is a lot of potential for growth of the industry in the coming years, considering the actual insurance coverage in India vis a vis the optimum coverage expected. Even during the last few years, the growth can be seen as phenomenal, which is of course good news for the Chartered Accountants fraternity. The sector offers scope for Chartered Accountants as statutory auditors, internal auditors, as tax consultants etc. Also, it gives a very promising career as a Financial Consultant, for which he has to spend less hours of training as compared to others. ■