Course No. 301 **ADVANCED FINANCIAL ACCOUNTING (AFAC IX)**

Marks: 80 **Hours: 40**

Objective: The basic aim of this paper is to acquaint the students with advanced topics in accounting.

Course Contents:

Unit I: **Accounts of Banking Companies :**Definition and meaning of banking terms, books to be maintained; classification of Advances, preparation of profit & loss A/C and Balance sheet.

20 : 10 hrs

Unit II: Accounts of Life Insurance Companies :Definition and elements of Insurance contract, meaning of various insurance terms, types of insurance, Books, maintained under life Insurance Business, Ascertainment of profit in life Insurance Business, Preparation of Revenue Account, Balance sheet and valuation Balance sheet of life Insurance company,

20 : 10 hrs

Unit III: Accounts of General Insurance Companies : Preparation of Revenue Account and Balance Sheet of General Insurance companies.

20 : 10 hrs

Unit IV: Investment Account : Meaning, meaning of cum-dividend and ex-dividend transactions, cum-interest and ex-interest transactions, brokerage, Accounting for investment.

20 : 10 hrs

Text and Reference Books :

1. Tulsiram: Financial Accounting. Pearson Education, New Delhi.
2. Rajaseharam: Financial Accounting. Pearson Education, New Delhi.
3. Mukherji & Hanif: Financial Accounting, Tata Mc. Graw Hill, New Delhi.
4. Paul: Advanced Financial Accounting, New Central Book Agency, Hyderabad.
5. Sukla, Grewal and Gupta: Advanced Accounts, S.Chand, New Delhi.

Unit – 2: Accounts of Life Insurance Companies

Concept of Life fund of an Insurance Company

Life Fund, also known as Life Assurance Fund is concerned with Life Insurance (Assurance) business. It is an item that appears on the liability side of the company's Balance Sheet. For insurance business, claim is an expenditure while premium is an income. As we all know, the difference between income (premium received) and expenditure (claims paid) should be the profit. In case of life insurance business this approach would pose a problem.

The income premium, is collected periodically (monthly, quarterly, annually) on policies that mature over a long period of time. The expenditure claim, has to be paid either on the maturity of the policy or on the death of the policy holder. Claim as an expenditure is definite while premium as an income is uncertain. The expected amount of premium on a policy will be received only if the policy holder is alive up to the maturity of the policy.

Therefore life insurance companies treat the difference between income and expenditure as a surplus and not profits. This surplus from the revenue account is transferred to the Life Fund, where it gets accumulated. Life fund is shown in schedule – 6 of the balance sheet under the head "Reserves and Surplus".

Basis Balance Sheet Valuation Balance Sheet

1. Purpose The purpose is to show financial position. The purpose is to calculate the surplus or deficiency of a Life Insurance Company

2.Information about profits It provides information as to profitability and financial position of the firm. It provides information about net liability and estimated surplus or deficiency.

3. Statement or Account. Balance Sheet is not an account but only a statement of assets & liabilities. Though termed as Valuation Balance sheet, it is basically a account.

4. Equality Total of assets side must be equal to the total of liabilities side. Valuation Balance Sheet shows a balance which is surplus or Deficiency of the Life Insurance company.

5. By whom it is prepared. It is prepared in prescribed format by every firm and company It is prepared by a Life Insurance Company.

6. Nature Balance is historical in nature. Net liability in valuation balance sheet is calculated on the basis of future liability and premiums.

Net Liability is useful to compute the profits of a life insurance business. It is the estimated liability on all the policies that are in force. The Net Liability is valued by an actuary. Hence it is called Net Liability as per actuarial valuation. The difference between Life Fund and Net Liability is the profits. Once in every two/three year's life insurance companies calculate profits and distribute it among policy holders and shareholders in the ratio of 19:1 or in any other suitable ratio.

Determination of Profit in Life Insurance Business by preparing valuation balance sheet

A life policy is generally taken for a number of years. The premium received for such long-term contracts cannot be treated as income for ascertaining the profits for that year. For example, under a contract of annuity only one premium as initial payment is received whereas the annuitant is required to be paid annuity till he dies. In case of life insurance, the claim must arise either on death or expiry of the period of the policy, whichever is earlier. That the future premium may or may not be received depends on the existence of the insured. Thus on a particular date a liability of the corporation is to be calculated as the premiums to be received in future will generally be less than the amount payable as claims. There is a gap between claims which are expected to arise and premiums which are expected to be received. This gap is known as net liability. Thus it becomes desirable to create a reserve equal to its net liability in order to ascertain the profit made by the corporation. The Life Insurance Corporation of India makes the valuation of its net liability every year in order to ascertain its profit. This is done by a person known as actuary and is a highly complicated mathematical process. For calculating net liability, the actuaries calculate the present value of future liability on all the policies in force as well as present value of future premium to be received on policies in force. The excess of the present value of future liability over the present value of future premium is called net liability as per actuarial valuation.

The balance in the life assurance fund cannot be taken as the profit made by the life insurance business. For the purpose of ascertaining the profit, the insurance company should calculate its net liability as per actuary and compared it with life assurance fund on a particular date in order to calculate the surplus/deficiency. This comparison is made by preparing a valuation Balance Sheet. If the life insurance fund is more than the net liability, the difference represents the surplus. On the other hand, the excess of net liability over the life assurance fund represents deficiency for the inter-valuation period. A specimen form of valuation balance sheet is given as follows:

Valuation Balance Sheet

As on date.............................

To Net Liabilities per actuary's valuation To Surplus		By Life Assurance funds as per Balance Sheet By Deficiency	

Only surplus (and not deficiency) will be shown in the Balance sheet. With profit policyholder have a right to participate in the profit of life insurance business to the extent of 95% of true profit and remaining 5% is shareholder's share. For calculation of true profit, surplus as disclosed by valuation Balance Sheet must be adjusted by:

a) Adding interim bonus (if any) as it is really advance payment of bonus.

b) Deducting any expenses still to be incurred.

Out of 95% of true profit, interim bonus already paid should be deducted to calculate the amount due to the policyholder.

Difference between General Balance Sheet and Valuation Balance Sheet

Difference between General Balance Sheet and Valuation Balance Sheet

Basis	Balance Sheet	Valuation Balance Sheet
1. Purpose	The purpose is to show financial position.	The purpose is to calculate the surplus or deficiency of a Life Insurance Company
2.Information about profits	It provides information as to profitability and financial position of the firm.	It provides information about net liability and estimated surplus or deficiency.
3. Statement or Account.	Balance Sheet is not an account but only a statement of assets & liabilities.	Though termed as Valuation Balance sheet, it is basically a account.
4. Equality	Total of assets side must be equal to the total of liabilities side.	Valuation Balance Sheet shows a balance which is surplus or Deficiency of the Life Insurance company.
5. By whom it is prepared.	It is prepared in prescribed format by every firm and company	It is prepared by a Life Insurance Company.
6. Nature	Balance is historical in nature.	Net liability in valuation balance sheet is calculated on the basis of future liability and premiums.

General Instruction for Preparation of Financial Statements of life insurance companies

1. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet, Revenue Account, Profit and Loss Account and Receipts and Payments Accounts shall be given.

2. The figures in the financial statements may be rounded off to the nearest thousands.

3. Interest, dividends and rentals receivable in connection with an investment should be stated at gross amount, the amount of income tax deducted at source should be included under 'advances taxes paid and taxes deducted at source'.

4. For the purposes of financial statements, unless the context otherwise requires:

a) The expression 'provision' shall, subject to (II) below mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy;

b) The expression 'reserve' shall not, subject to as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability or loss;

c) The expression 'capital reserve' shall not included any amount regarded as free for distribution through the profit and loss account; and the expression 'revenue reserve' shall mean any reserve other than a capital reserve.

d) The expression 'liability' shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

5. Where:

a) Any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or

b) Any amount retained by way of providing for any known liability or loss, is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated as a reserve and not provision.

6. The company shall make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.

7. Extent of risk retained and re-insured shall be separately disclosed.

8. Any debit balance of the Profit & Loss Account shall be shown as deduction from uncommitted reserves and the balances, if any, shall be shown separately.

PROFORMA OF REVENUE ACCOUNT AND PROFIT AND LOSS ACCOUNT OF A LIFE INSURANCE COMPANY

Name of the Insurer: Registration No. and Date of Registration with the IRDA

FORM A-RA

REVENUE ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20…..

Policyholder's Account (Technical Account)

No.	Particulars	Schedule	Current Year	Previous Year

			(Rs.'000)	(Rs.'000)
	Premiums earned – net	**1**		
	(a) Premium			
	(b) Reinsurance ceded			
	(c) Reinsurance accepted			
	Income from Investments			
	(a) Interest, Dividends & Rent – Gross			
	(b) Profit on sale/redemption of investments			
	(c) (Loss on sale/redemption of investments.)			
	(d) Transfer/Gain on revaluation/change in fair value'			
	Other income (to be specified)			
	Total (A)			
	Commission	**2**		
	Operating Expenses related to insurance Business	**3**		
	Provision for doubtful debts Bad debts written off			
	Provisions (other than taxation)			
	(a) For diminution in the value of investments (Net)			
	(b) Others (to be specified)			
	Total (B)			
	Benefits Paid (Net)			
	Interim Bonuses Paid			
	Change in valuation of liability in respect of life policies	**4**		
	(a) Gross"			
	(b) Amount ceded in Reinsurance			
	(c) Amount accepted in Reinsurance			
	Total (C)			
	Surplus (Deficit) (D) = (A) – (B) – (C) Appropriations			
	Transfer to Shareholders' Account			
	Transfer to Other Reserves (to be specified) Balance being Funds for Future Appropriation			
	Total (D)			

Name of the Insurer: Registration No. and Date of Registration with the IRDA

FROM A-PL

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20…..

Shareholder's Account (Non-technical Account)

No.	Particulars	Schedule	Current Year (Rs.'000)	Previous Year (Rs.'000)
	Amounts transferred from/to the Policyholders account (Technical Account)			
	Income From Investments			
	(a) Interest, Dividends & Rent – Gross			
	(b)Profit on sale/redemption of investments			
	(c)(Loss on sale/redemption of investments)			
	Other Income (To be specified)			
	Total (A)			
	Expenses other than those directly related to the insurance business			
	Bad debts written off			
	Provisions (Other than taxation)			
	(a) For diminution in the value of investments (Net)			

	(b) Provision for doubtful debts **(c) Others (To be specified)** **Total (B)** **Profit (Loss) before tax Provision for Taxation** **Profit/(Loss after tax Appropriations** **(a) balance at the beginning of the year** **(b) Interim dividends paid during the year** **(c) Proposed final dividend** **(d) Dividend distribution tax** **(e) Transfer to reserves/other account** **(to be specified)** **Profit carried…………………….to the Balance Sheet**			

Explanation of various items appeared in Revenue Account

1) Claims: Any amount payable by the insurance company is called a claim. In life insurance business, claims may arise due to two reasons i.e. by death or maturity. While calculating the figure for claims, all claims intimated & accepted or not accepted at the end of the year, expenses relating to claims are to be added & out of the total, claims outstanding at the beginning of the year and reinsurance recoveries are to be deducted.

2) Annuity: It is an annual payment which a life insurance company guarantees to pay for lump sum money received in the beginning. It is an expense and shown under the head benefits paid (Schedule 4).

3) Surrender Value: It an insured is unable to pay the further premium, he can get his policy paid from the corporation. It is the present cash value of the policy which a holder gets from the corporation on surrendering all the rights of the policy.

4) Bonus in cash: If the insurer has with profit policy, he will get the bonus from the corporation. If the bonus is paid in cash, it is shown on the debit side of the revenue A/c as an expense.

5) Bonus in Reduction of Premium: Instead of paying bonus in cash, the insurer may deduct the bonus from the premium due from the insured. This is known as bonus in reduction of premium.

6) Premium: The premium received during the accounting period plus outstanding at the end of the period, plus bonus in reduction of premium minus outstanding premium at the beginning of the period minus reinsurance premium is to be shown under the heading “Premium earned (Net)” (Schedule1)

7) Registration fees: This is an item of income & shown as other income in the revenue A/c.

8) Reinsurance: When a company accepts a business of more value & in order to reduce the risk may pass on some business to the other company, it is called reinsurance.

Books maintained by All Insurance Companies

Under the Insurance Act, 1938 it is obligatory on the part of all insurance companies including the general insurance companies to maintain the following books which may be called 'statutory books'.

1. The registrar of policies: This book contains the following particulars in respect of each policy issued:

a) The name and address of the policyholders.

b) The date when the policy was affected.

c) A record of any assignment of the policy.

2. The registrar of claims: This book should contain the following particulars in respect of each claim:

a) The date of claim.

b) The name and address of the claimant.

c) The date on which the claim was discharged.

d) In the case of a claim which is rejected, the date of rejection and the ground for rejection.

3. The register of licensed insurance agents: This book should contain the following particulars in respect of each agent:

a) Name and address of every insurance agent appointed.

b) The date of appointment.

c) The date on which appointment ceased, if any.

In addition to the statutory books mentioned above, insurance companies also maintain the **following subsidiary books** for recording the transactions:

a) Proposal register.

b) New premium cash book.

c) Renewal premium cash book.

d) Agency and branch cash book.

e) Petty cash book.

f) Claims cash book.

g) General cash book.

h) Agency credit journal.

i) Agency debit journal.

j) Lapsed and cancelled policies book.

k) Chief journal.

l) Commission book.

m) Agency ledger.

n) Policy loan ledger.

o) General loan ledger.

p) Investment ledger.

Types of bonuses given by a Life Insurance Company

a) Simple Reversionary bonus (SRB) This type of bonus is calculated on the sum assured only. This bonus is declared annually and is accrued to be paid out at the time of a claim or maturity.

b) Compound Reversionary bonus (CRB) CRB is calculated as a percentage of the sum assured and all previously accrued bonuses. The bonus of each year is added to the sum assured and the next year's bonus is calculated on the enhanced amount.

c) Terminal Bonus: The terminal bonus, also known as a persistency bonus, is a bonus paid to indicate an overall performance of a participating policy. The terminal bonus is paid at the time of maturity or death of the life assured. This form of bonus may be given after staying in the policy for a pre-determined time period and is offered at the discretion of the insurer.

d) Interim Bonus: Interim bonus is payable for those policies that mature or result in a death claim in between two bonus declaration dates. While the policy has already accrued the bonus declared at the end of the last financial year, there may be a short period in between the bonus declaration date and the maturity/claim date for which the policy has not received bonus. In such instances, bonus is added on a pro-rata basis using the interim bonus rates declared by the company. An interim bonus ensures that policyholders who claim benefits in midst of a year will receive credit for keeping the policy in force for that part of the year.

e) Cash Bonus The insurance company may decide to give the bonus in cash, i.e. bonus accruing in a year will be paid to the policyholder at the end of the year. This gives the policyholder an opportunity to receive the bonus year on year rather than the usual way of accruing till bonus maturity.

Difference between Whole life policy and Endowment Policy

Whole life Policy: Under this policy premiums are paid throughout life and the sum insured becomes payable only at the death of the insured. The policy remains in force throughout the life of the assured and he continues to pay the premium till his death. This is the cheapest policy as the premium till his death. This is the cheapest policy as the premium charged is the lowest under this policy. This is also known as ‘ordinary life policy’. This policy is suitable to persons who want to provide for payment of estate duty, make contribution for charitable purposes and to provide for their families after their death.

Endowment policy: It runs only for a limited period or up to a particular age. Under this policy the sum assured becomes payable if the assured reaches a particular age or after the expiry of a fixed period called the endowment period or at the death of the assured whichever is earlier. The premium under this policy is to be paid up to the maturity of the policy, i.e., the time when the policy becomes payable. Premium is naturally a little higher in the case of this policy than the whole life policy. This is a very popular policy these days as it serves the dual purpose of family and ole age pension.