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 – 3: Financial Statements of General Insurance Companies

Meaning of General Insurance

Insurance contracts that do not come under the ambit of life insurance are called general insurance. The different forms of general insurance are fire, marine, motor, accident and other miscellaneous non-life insurance. The tangible assets are susceptible to damages and a need to protect the economic value of the assets is needed. For this purpose, general insurance products are bought as they provide protection against unforeseeable contingencies like damage and loss of the asset. Like life insurance, general insurance products come at a price in the form of premium.

Features of General Insurance Companies:

a) General Insurance policy is a contract of indemnity in which the insurer agrees to reimburse only the actual loss suffered subject to the average clause.

b) General Insurance contract is for a short period usually a year.

c) The subject matter is any physical property, assets, ship or cargo etc.

d) General insurance has only the element of protection and not the element of investment.

e) Insurable interest on the subject matter must be present both at the time of effecting policy as well as when the claim falls due.

f) General insurance is a contract of indemnity. The insured can claim only the actual amount of loss from the insurer.

g) General insurance does not have any surrender value or paid up value.

h) In case of general insurance, business profit is determined after making provision for unexpired risks.

i) Loss is measurable in case of general insurance.

Difference between Life insurance and General Insurance

Basis of difference	Life Insurance	General Insurance
Subject Matter	**The subject matter of insurance is human life.**	**The subject matter is any physical property, assets, ship or cargo etc.**
Element	**Life Insurance has the elements of protection and investment or both.**	**General insurance has only the element of protection and not the element of investment.**

Basis of difference	Life Insurance	General Insurance
Insurable Interest	**Insurable Interest must be present at the time of affecting the policy.**	**Insurable interest on the subject matter must be present both at the time of effecting policy as well as when the claim falls due.**
Duration	**Life Insurance policy usually exceeds a year and is taken for longer period ranging from 5 to 30 years or whole life.**	**General insurance policy usually does not exceed a year**
Indemnity	**Life insurance is not based on the principle of indemnity.**	**General insurance is a contract of indemnity. The insured can claim only the actual amount of loss from the insurer.**
Loss measurement	**Loss is not measurable.**	**Loss is measurable.**
Surrender value or paid up value	**Life insurance policy has a surrender value or paid value.**	**General insurance does not have any surrender value or paid up value.**
Contingency of risk	**There is an element of certainty.**	**There is an element of uncertainty and there may be no claim.**

Final Accounts of General Insurance Companies

Final account of general insurance business are required to be prepared as per IRDA Regulations, 2002 which consist of:

(a) Revenue Account (as per Form B-RA);

(b) Profit and Loss Account (Form B-PL);

(c) Balance Sheet (Form B-BS).

1. Revenue Account: A separate Revenue Account (Form B-RA) is prepared for each type of business e.g., fire, marine etc. It records the incomes and expenses of a particular business and profit/loss is transferred to Profit and Loss Account.

2. Profit and Loss Account: (Form B-PL) Besides, profit/loss of different business, it records incomes and expenses of general nature and it shows how the profit has been appropriated. Its balance is shown in the Balance Sheet.

3. Balance Sheet: (Form B-BS) It records various assets and liabilities of the General Insurance Companies.

Determination of Profits in case of general insurance companies

It must be observed that difference in revenue account does reveal profit or loss of business. The revenue account is closed by transfer to respective fund account viz., fire fund, marine fund etc.

Ascertainment of profit under General Insurance Business.

General insurance policies are normally issued for short terms renewable every year.

It is quite possible that on the accounting date, some of the contracts are still alive and hence represent unexpired risk. A suitable provision is made for that unexpired risk on a generalized basis as it is impractical to create it for specific policies. Sometimes an additional provision is also created. The total of reserve for unexpired risk and additional risk is collectively termed as 'Respective Fund' which may be fire fund, marine fund, motor vehicle fund, etc. The revenue account starts and ends with respective value of the fund besides recording normal revenue and expenditure. The difference of the account is called profits or loss and is transferred to Profit and Loss Account.

Ascertainment of profit under General Insurance Business.

General insurance policies are normally issued for short terms renewable every year.

Reserve for unexpired risk and its significance at the time of calculating profits

Insurance Company, close their accounts on 31st March but not all risks under different policies expire on that date. Many policies extend into the following accounting year during which the risk continues. Therefore on the closing date there is an unexpired liability under various policies which may occur during the remaining term of the policy beyond the year and therefore, a provision for unexpired risks is made. This reserve is based on the Net Premium income earned by the insurance company during the year.

The effort involved in calculating unexpired portion of premium under each policy is very time consuming. Therefore, a simple formula to derive a percentage of premium income to be allocated to reserve for unexpired risks is adopted.

According to the requirements of the Insurance Act, it is sufficient if the provision is made for unexpired risks at 50 per cent for Fire, Marine Cargo and Miscellaneous business except for Marine Hull which has to be 100 per cent. It may be mentioned that the insurance companies are governed by the provisions of Section 44 of the Income-tax Act, 1961. In this regard, Rule 5 of the First Schedule to the Income-tax Rules – computation of Profit & Loss of General Insurance Business – provides for creation of a reserve for unexpired risks as prescribed under Rule 6E of the said Rules. According to this Rule, the insurance companies are allowed a deduction of 50 per cent of net premium income in respect of Fire and Miscellaneous Business and 100 per cent of the net premium income relating to Marine Insurance business. In view of this the reserves are created at the rates allowed under the Income-tax Act.

Additional reserve for unexpired risk

Ø In a particular year the management may feel that the percentage of premium recommended by the General Insurance Council is not sufficient to meet the unexpired risks. In such a situation they may provide additional reserve. Such additional reserve for unexpired risk will also be debited to the revenue account.

Ø The balance will be shown in the balance sheet as in the case of normal reserve for unexpired risk, and will be transferred to the credit of next year's revenue account.

Treatment of reserves for unexpired risk: Reserve for unexpired risk is adjusted with premium earned in schedule – 1 of the Revenue account of a general insurance company. Difference in opening and closing balance of reserve for unexpired risk is calculated and increase in reserves during the year is deducted with premium earned or vice-versa. In balance sheet, reserve for unexpired risk is shown in schedule – 14 under the head provisions.

General Instruction in preparation of Final Accounts of General Insurance Companies

Following are the important points which should be kept in mind while preparing the final accounts of general insurance companies:

1. General insurance company may be doing more than one business, e.g., fire, marine accidental etc. For each type of business a separate Revenue Account is to be prepared in the prescribed from B-RA.

2. Reserve for Unexpired Risks: The need for unexpired risks reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts

on a particular date, not all risks under policies expire on that date. Many policies normally extend beyond this date into the following year during which risks continue. In other words, at the closing date, there is unexpired liability under various policies, which may occur during the remaining term of the policy beyond the year end.

According to the requirements of the Insurance Act, it is sufficient if the provision is made for unexpired risks at 50 per cent for Fire, Marine Cargo and Miscellaneous business except for Marine Hull which has to be 100 per cent. Some prudent companies may make additional reserve also in case of fire and accidental insurance in order to cover the full liability as and when it arises.

The Executive Committee of the General Insurance Council, set up under the Insurance Act for the supervision of general insurance companies, has provided that in case of marine insurance, the provision against unexpired risk should be 100% of net premium and in case of other general insurance business such as fire, accident, theft, etc. reserve against unexpired risk should be 40% of the net premium income. However, the income Tax Authorities allow a provision of 50% of net premium income in respect of fire and Miscellaneous business and 100% of net premium in case of marine insurance. Therefore, the practice with the general insurance companies is to maintain 50% of net premium income as reserve against unexpired risk in case of fire, accident, theft, etc. and 100% in case of marine insurance. An insurance company can also make additional reserve in addition to usual reserve if it feels necessary.

3. A combined Balance Sheet is also prepared in the prescribed form for all business on the closing date of the year.

4. Commission on policies affected through insurance agents cannot exceed 5% of the premium in respect of fire and marine business and 10% in case of miscellaneous business. In case of policies are effected through a principal agent, the maximum limits are 20% for fire and marine policies and 15% in case of miscellaneous insurance less any commission payable to an insurance agent in respect of the policy concerned.

5. Claims paid must include all expenses directly incurred in setting claims such as legal expenses, medical expenses, surveyor's expanses etc.

6. No claim of Rs. 20,000 or more can be paid, except as the Controller of Insurance may otherwise direct, unless there is a report in respect thereof from an approved surveyor or loss assessor (licensed under the Insurance Act.)

7. **An insurer carrying on general insurance** business, after the commencement of Regulations given by the Insurance Regulatory and Development Authority on 30th March, 2003, shall comply with the requirements of Schedule B for the preparation of financial statements, management report and auditor's report. Schedule B as given by IRDA is reproduced on.

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

FORM B-RA

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

Policyholder's Account (Technical Account)

No.	Particulars	Schedule	Current Year (Rs.'000)	Previous Year (Rs.'000)
	Premium Earned (Net)	**1**		
	Profit/Loss on sale/Redemption of Investments			
	Other (to be specified)			
	Interest, Dividend & Rent – Gross			
	Total (A)	**2**		
	Claims Incurred (Net)	**3**		
	Commission	**4**		
	Operating Expenses related to Insurance Business			
	Total (B)			
	Operating Profit/Loss from Fire/Marine/ Miscellaneous Business C = (A-B)			
	APPROPRIATIONS			
	Transfer to Shareholders' Account			
	Transfer to Catastrophe Reserve			
	Transfer to Other Reserves (to be specified)			
	Total (C)			

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

FROM B-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)
	Operating Profit / (Loss) **(a) Fire Insurance** **(b) Marine Insurance** **(c) Miscellaneous Insurance Income from Investments** **(a) Interest, Dividend & Rent – Gross** **(b) Profit on sale of Investments** **Less: Loose on sale of Investments** **Other Income (To be specified)** **Total (A)** **Provisions (Other than taxation)** **(a) For diminution in the value of investments (Net)** **(b) For doubtful debts** **(c) Others (To be specified)** **Other Expenses** **(a) Expenses other than those related to Insurance Business.** **(b) Bad Debts written off.** **(c) Others (to be specified)** **Total (B)** **Profit before tax Provision for Taxation Profit after tax** **Appropriations** **(a) Interim dividends paid during the year** **(c) Proposed final dividend** **(d) Dividend distribution tax**			

	(e) Transfer to reserves/other account (to be specified) Balance of Profit/Loss brought forward from last year. Balance Carried forward to the Balance Sheet			

Re-Insurance

In general insurance there are risks which, because of their magnitude or nature, one insurance company cannot afford to cover, e.g. aviation insurance. Generally, in such cases, an insurance company insures the whole risk itself and lays off the amount it has accepted to other insurance of reinsurance companies, retaining only that much risks which it can absorb.

A reinsurance transaction may thus be defined as an agreement between a 'ceding company' and a 'reinsurer' whereby the former agrees to 'cede' and the latter agrees to accept a certain specified share of risk or liability upon terms as set out in the agreement.

A 'ceding company' is the original insurance company which has accepted the risk and has agreed to 'cede' or pass on that risk to another insurance company or a reinsurance company. It may however be emphasized that the original insured does not acquire any right under a reinsurance contact. In the event of loss, therefore, the insured's claim for full amount is against the original insurer.

In other words, if an insurer is not willing to bear the whole of the risk, it reinsures itself. Some risk retains with some other insurer. This is called as reinsurance. Both re-insurer and original insurer share the premium and risk in the same proportion and decided by them earlier.

Double insurance

Double insurance is the insuring of an individual, dependent, or personal property by two or more insurance companies. Such dual insurance allows those with coverage to claim the full amount from the policies; however the total claim cannot exceed the actual loss or cost associated with the underwritten subject of the policies. Insurance companies are law bound to honor double insurance policies, but the recipient of such policies must satisfy certain eligibility requirements. Underwriters of double insurance policies have the ability to reject or appeal certain claims based on deception or unjust enrichment. Consequently, it is important that individuals insurable under

double insurance have an understanding of the independent insurance policies that comprise their dual coverage and know the process for claims and payouts.

Difference between reinsurance and double insurance The concept of double insurance differs from the concept of reinsurance the following respects:

(a) MEANING: The reinsurance business is entered into by the original insurer with the order insurers. But in double insurance, but the insured gets the same subject matter insured with more than one insurer or under more than one policy with the same insurer.

(b) FILLING CLAIM: In reinsurance, the insured cannot be claim any part of the his loss from the insurer. But in the double insurance the insured can claims only his actual loss from each of the insurers up to the amount insured with them.

(C) CONTRIBUTION: In reinsurance, the reinsured will claim a part of the loss proportionate to the risk reinsured by the him with the reinsurers. But in double insurance, each insurer is liable to contributions on prorata basis towards the loss suffered by the insured.

DIFFERENCE BETWEEN ASSURANCE AND INSURANCE

Both these two terms are used synonymously in the context while the term insurance is a used in other types if insurance like fire or marine. Assurance refers to a contract in which the sum assured is bound to be payable sooner or later. But a contract of insurance is a contract for compensation of damage or loss and the question of claim does not arise in the cases there is no loss. Thus the term insurance is used when the risk is undertaken and in such cases the policy does not become a claim. But in case of assurance, the policy is bound to become a claim in the stipulated manner.

The insured may die in the course of the term of the policy or else he is bound to attain a particular age. In common usage, the terms are very widely used to mean one and the same thing.

DIFFERENCE BETWEEN INSURANCE AND WAGERING AGREEMENTS Insurance contracts are not wagering or gambling contracts, such as a betting on the turn of a card or on horse racing etc., In a wagering contract, both parties, create a risk and want to make money the happening or otherwise of an event, while in the case of insurance, risk already exists and the purpose of contract is only the transfer the risk. Though there is a uncertainty and payments is made on the happening of the event in both the

cases. , really is it not so. the following are the differences between these two contracts.

(1) PURPOSE: The object of insurance is to protect the insured against loses on the happening of some uncertain future events. the object of a wager is a to make profit by winning.

(2) RISK: Insurance is meant for protection, if the risk, which is already there, materializes. But the risk is oriented in wagering contracts. Surrender value and Paid-up value

Surrender Value: The term surrender value indicates the value that we receive from the insurance issuer after we surrender the policy before maturity. Surrender, here, means termination or cancellation of the life policy or returning the policy to the insurance company before the stipulated time. The policy no longer exists after the company clears off the payment to the policyholder. There can be a number of reasons behind surrendering our policy. One of the most common reasons is inability to pay the premiums. The policyholders often feel they have chewed more than they can swallow. Surrendering our policy means we will not have to pay premiums any further. When we terminate a policy, the company pays us certain amount because we have paid premiums in the previous years of which a portion has been used to cover risk, and another portion has been used as an investment. The investment portion with its increased value will be returned to us after deducting some termination charges. We might even get some bonus as well. This amount is known as the surrender value. However, keep in mind that the surrender value factor plays a key role in minimising the bonus.

Paid-up Value: It may occur that we do not want to pay the premiums of the policy, but you want to keep the policy. The insurance companies have a solution for this one too. The insurance company will offers us an option where we can have our policy, but the company will have no premium expectations from us. But there is a catch in this. The assured sum of the policy, when it was taken will be reduced considerably. This is done through a calculation called paid-up process. The calculated amount is known as the paid-up value. Formula to calculate the above two:

1. Surrender Value = [{(Number of premiums paid/number of payable premiums)* Assured Sum of money} + total bonuses] * Surrender value factor
2. Paid-up Value = (Number of premiums paid/ total number of payable premiums)* assured sum of money.