Audit of Life Insurance Companies – An Insight

Considering the multifold growth of life insurance companies, huge business volume and complex IT environment, it has become imperative for an auditor to go beyond the normal audit techniques of sampling and vouching and use modern techniques, including data analytics to enhance the effectiveness of the audit. Moreover, the rapidly changing laws and regulations require auditors to be continuously aware of their increasing roles and additional responsibilities including expressing an opinion on adequacy and operating effectiveness of internal financial controls over financial reporting. Continue reading what minimum diligent duties/procedures an auditor should perform while carrying out the audit of life insurance companies…

Life Insurance Industry – An Overview

Since 2000, the Indian insurance industry underwent liberalisation and privatisation, and information technology (IT) played a key role in revolutionising the insurance sector. We saw recently, the introduction of a complete new set of laws (the Insurance Laws (Amendment) Act, 2015 and its cascading regulations) governing the insurance companies. The amendment Act aims to 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 and permits a foreign reinsurer to set up a branch office in India.

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Life insurance companies are primarily involved in selling of products under two broad segments - traditional/conventional products (having profit participating and non-participating features) and unit linked products (ULIPs) (market linked investment policies). ULIPs are similar to mutual fund schemes and additionally cover life risk of policyholders.

Unique Features of the Life Insurance Industry

A few features that make insurance companies unique in certain aspects:

- Insurance products (including all terms and conditions) are duly approved by the Insurance Regulatory and Development Authority of India (IRDAI)

- Prescribed format for preparation of financial statements
- Actuarial valuation of liabilities: Role of actuaries is significant for ascertainment of future liabilities in respect of insurance policies issued by the company
- Segregation of funds between shareholders and policyholders
- Recognition and measurement principals of certain items of financial statements (such as premium, investments, commission, *etc.*) governed by IRDAI regulations
- Mandatory appointment and rotation of joint auditors
- Maintenance of solvency margin ratio
- Income tax calculation under Section 44 (Sections 28 to 43B are not applicable), First Schedule and Section 115 B of the Income-tax Act, 1961
- Mandatory audit for transfer of surplus to shareholder during the interim periods.

Preparation of Financial Statements

Preparation of financial statement of life insurance companies is governed by Schedule A of the IRDAI (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 ("Regulation" or "Financial Statement Regulation"). Post this regulation, IRDAI issued a master circular in 2013, on preparation of financial statements and filing of returns of life insurance business, detailing presentation, recognition, measurement and disclosure requirements for life insurance companies. This master circular consolidates all the circulars issued by the authority as appended to the circular and supersedes all the earlier circulars/ guidelines issued in this regard. IRDAI, with an objective of bringing further transparency and clarity, has on 17th November, 2015 issued an Exposure Draft on Preparation of Financial Statements and Auditors Report.

Applicability of Accounting Standards (AS)

The financial statements of the insurer should be in conformity with the AS referred to in Section 133 of the Companies Act, 2013, to the extent applicable to the insurers carrying on life insurance business except that:

- *AS 3 - Cash Flow Statements* – Only direct method is prescribed.
- *AS 17 - Segment reporting-* IRDAI has prescribed various segments to be disclosed in the financial statements.
- *AS 13 - Investments -* Valuation of investments should be in accordance with the valuation norms issued by the IRDAI.
- *AS 29 – Provisions, Contingent Liabilities and Contingent Assets* – Provision and contingent liabilities arising in insurance enterprises from contracts with policyholders have been excluded.

Format and Contents of Financial Statements

Format and contents of the financial statements is governed by the Regulation and various other circulars/orders/notification issued by IRDAI. The financial statements also include disclosure requirements mandated by other laws such as the Companies Act, MSMED Act, *etc.* The financial statements consist of:

- Revenue Account (Policyholders' Account)
- Profit and Loss Account (Shareholders' Account)
- Balance Sheet
- Schedules 1 to 15 in prescribed formats
- Receipts and Payments Account (i.e. the Cash Flow Statement)
- Segmental reports relating to Revenue Account and Balance Sheet
- Significant accounting policies and notes to accounts including ULIP disclosures.

Format of Auditors' Report

The Regulation mandates auditors to report on certain additional requirements/matters over and above the normal reporting norms given under Standard on Auditing 700 - *The Auditor's Report on Financial Statements.* Additional reporting/

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certifications are required to be made part of the Auditors' Report on the following:

- Actuarial Valuation of Liabilities: Actuarial valuation of liabilities is duly certified by the appointed actuary
- Compliance with IRDAI guidelines specifically in respect of investment valuation
- Contents of management report for inconsistencies with the Financial Statements
- Compliance with the terms and conditions of the registration
- Verification of cash balances and investment
- Compliance with the application of assets of policyholders' funds

The auditors' report format prescribed under the Exposure Draft - IRDAI (Preparation of Financial Statements and Auditors' Report of Insurers) Regulation 2015 includes a supplementary report which is similar to the Companies (Auditors Report) Order, 2015.

Shift in Stakeholders Expectation from Auditors

During the last couple of years, there has been a total shift in the way of conducting and managing business, complexity of business/transactions, IT environment and the regulatory and reporting landscape has changed significantly. Therefore, the expectations of stakeholders from the auditors have significantly changed and require auditors to perform more than the conventional approach – year end auditing based on sample checking. Stakeholders doesn't foresee audit as compliance requirements or mere a formality but expect round the year audit to be performed for early warnings, open communication and pragmatic resolution of issues which derives the maximum benefits and avoid last minutes discussions/hassles.

Audit Approach and Methodology

The basic audit approach and methodology for insurance industry is principally very similar to that followed in other industries. An auditor must devote significant time in understanding/updating themselves on IRDAI regulations, insurance products, *etc.* and their accounting and other relevant aspects of auditing at the inception of audit. It has also become imperative for an auditor to go beyond the normal audit techniques of sampling and vouching and use modern techniques of auditing including data analytics. Moreover, the rapidly changing laws and regulations have a cascading effect on the auditors' awareness about their increasing roles and additional responsibilities including expressing an opinion on adequacy and operating effectiveness of internal financial controls over financial reporting. Broad considerations while formulating the audit strategy are as under:

General Procedures

I.Risk Based Audit Approach:

At the planning stage, the auditor must identify the risks and define the audit strategy to be performed. The objective of this approach is to select high risk areas (i.e. suspense/control account, bank reconciliation, commission, investment, money laundering, *etc.*) with focused approach, and conduct systematic in depth audit. This approach emphasises on coverage of 'all major areas of risk' based on objective assessment of risk factors, their significance and materiality.

II. Internal Financial Control over Financial Reporting (ICoFR)

Auditors are required to report on adequacy and operating effectiveness of ICoFR effective from 1st April, 2015. Accordingly, auditors have to reassess and modify the existing audit approach and methodology basis the Guidance Note issued by the ICAI (the Guidance Note). The Guidance Note provides supplementary procedures that are required to be considered by auditors for planning, performing and reporting.

III. Complex IT Environment:

Due to voluminous transactions, business segments and varied reporting requirements, data recording, processing, interface, transmission and storage is handled through high level of computerisation. It is imperative to obtain a thorough understanding of the IT environment prevalent, application software used at all points of time during the year/period as well as interfaces established between several sub systems. Today the focus of audit is more on processes, products and controls and less on financial numbers. It would not be incorrect to state that around 70% to 80% of the time is devoted towards audit planning process consisting of mapping of business processes, understanding the industry developments, review of internal controls, understanding and review of IT environment, integration of IT systems, *etc.* and only remaining time is spent on audit execution and verification of financial numbers.

IV. Use of In-House Experts:

Due to the use of complex computerised environment, frequent changes in service tax laws and specific provisions of income tax for insurance industry, an auditor would do well to use the expertise of IT and tax professionals in their firm in addition to carrying out normal audit procedures. It is also necessary to obtain an understanding about the tax issues faced by the overall insurance industry and positions taken by the company wherever necessary in consultation with external expert.

V. Data Analytics:

Considering the voluminous transactions, complex IT environment and significance of the time, auditors should perform data analytics (by using MS-Access/data analytical tools) to review the full information, which enable auditors to analyse and interpret the data in a more meaningful way and effectively:

1. Automation of whole of the process from acceptance of premium/proposal to discharge of claim/claim settlement;
2. System integrations;
3. Logic and design of the IT system for specific activity;
4. IT System Issues, if any; *etc.*

It is necessary to have an understanding about the life cycle of policies within the policy admin system of life insurance companies. The various phases/stages/cycles of a life policy are In Force (active), Lapse (non-payment of premium within 3 years), Paid Up (non-payment of premium post 3 years), Surrender, Registered Death, Maturity (on completion of policy term), *etc.*

Performing data analytics would help auditors to obtain appropriate results for certain illustrative procedures enumerated below:

- Whether policy is still under In-force status though the premium is not received within due date including grace period?
- Whether policy is still under ULIP Lapse status after completion of its grace period for premium payment?
- Whether policy gets under Matured status after risk cessation date?
- Whether all in force policies of a policyholder has been appropriately dealt post receipt of intimation of death against one policy?

VI. Others:

The insurance companies generally have robust systems in place for defining the products and processes and these are well documented in the form of operating procedures, guidelines, manuals and circulars.

As an auditor, it is important to:

- Understand the business, products, internal control system and all the key / critical processes.
- Understand the process of updation of masters in IT configuration from file and use documents.
- Understand the issues existing in the insurance industry.
- Review the internal guidelines, circulars, process flows including accounting manual.
- Review of all the circulars, guidelines and notifications issued by IRDAI.
- Assess the overall internal/concurrent audit approach and review the scope and coverage of internal/concurrent auditors.
- Review of critical manual applications and controls thereon.
- Understand the process of application of cutoff procedures.
- Understand the process of vendor due diligence put in place before entering into transactions with vendors to ensure compliance with the outsourcing Guidelines issued by IRDAI.
- Understand the risk identification process and mitigation framework for each process.
- Perform walkthrough tests for understanding the processes and test the existence and effectiveness of controls.
- Effectiveness and assessment of critical controls, processes by substantive analytical procedures (SAP) / other substantive procedures (OSP).
- Benchmark the accounting policies and practices with peers.
- Continuously monitor circulars/orders issued to company and peer companies by IRDAI.
- Review correspondence with the statutory authority including inspection reports.
- Verify the reconciliation between various systems – front end *vis-à-vis* accounting system.

Specific Procedures

Premium Income and Related Accounts:

Insurance company collects premium in two modes- single premium (one time) and regular premium including first year premium (monthly, quarterly, half yearly and annually). It is important for the auditor to consider the procedures summarised in the following table:

PROCEDURES	DETAILS
• Basic understanding	• Understand the process from receipt of proposal form till recognition of premium income and the accounting entries recorded at each stage. • Understand the process of compliance with AML/KYC guidelines including reporting requirements. • Understand the underwriting guidelines (financial and non-financial) and product features. • Understand the treatment relating to free look-in cancellation of policy and cheque bounce subsequent to balance sheet date and consequent effect on commission, actuarial liabilities, reinsurance, *etc.* • Understand the process of monitoring of premium suspense account.
• Substantive procedures and Test of controls	• Walkthrough the above processes. • Review all suspense/control accounts to assess the control and monitor thereof. • Ensure compliance with application of NAV for ULIPs. • Review mechanism and reporting made to FIU towards suspicious transaction(s) (based on company's own assessment) and cash transactions (above ₹10 Lakh)
• Compliance	• Adherence to AML policy formulated by the insurance company in accordance with the IRDAI guidelines. • File and Use - filed and approved by IRDAI. • Rural and social norms of IRDAI by understanding the process of identification of rural and social regions. • Regulation related to linked and non-linked insurance products issued by IRDAI in 2013. • Financial Statement Regulation and Master Circular on financial statements.

Commission:

Acquisition cost paid to insurance advisors (individuals and corporate), brokers, referral and bancassurance constitutes the major portion of the expenses of an insurance company. It is important for the auditor to consider the procedures summarised in the following table:

PROCEDURES	DETAILS
• Basic understanding	• Understand the process from accrual to payment of commission and accounting entries recorded at each stage. • Process of termination of agents including termination on license expiry. • Company's policy/guidelines for acceptance of new business post expiry of license (viz. under renewal). • Controls in place for compliance with Section 40A for limitation on expenditure on commission.
• Substantive procedures and Test of controls	• Perform walkthrough of the above processes. • Verify rates of commission and compliance with IRDAI regulations. • Check the reconciliation of premium as per commission register to premium register.
• Compliance	• Tax deducted at source on commission. • Service tax. • Section 40A on 'limitation of expenditure on commission.' • Section 44 on 'prohibition of cessation of payments.' • Other IRDAI regulations/guidelines related to brokers, corporate agents, bancassurance, referral arrangement, *etc.*

Benefits (Claims) Paid:

Claim - a demand for the payment of policy benefit because of occurrence of an insured event comprises of claim by death, maturity, annuities / pensions payment, other benefits such as surrenders, lapse liability, *etc.* It is important for the auditor to consider the procedures summarised in the following table:

PROCEDURES	DETAILS
• Basic understanding	• Process of benefits paid from receipt of application of claim to the payment of claim and accounting entries recorded at each stage. • Process of identification and investigation of suspicious and contestable claims. • Process of monitoring disputes between the company and claimants. • Process of application of NAV on receipt of claims (for ULIP policies). • Role of actuaries for claims outstanding at each reporting date. • Process adopted by companies for making claims payments under lender borrower group schemes.
• Substantive procedures and Test of controls	• Perform walkthrough of the above processes. • Check whether on acceptance of claim or on maturity, the status of the policy in the system is updated. • Assess the control over the unclaimed amount and efforts for the discharging the same. • Review respective suspense accounts. • In respect of litigation matters, ensure that provision made towards the same is after making appropriate adjustments towards liability existing in the books (e.g. actuarial liability, unit linked liability, claim recoverable from reinsurance, *etc.*)
• Compliance	• Internal guidelines. • Compliance with IRDAI regulations, specific orders, directives, *etc.* • Section 194DA of the Income-tax Act, 1961. • Financial Statement Regulation and Master circular on financial statements. • Handling of the unclaimed amount pertaining to the policyholders.

Investment:

As per the IRDAI, the investments related to policyholders and shareholders need to be separately disclosed in the financial statements. It is important for the auditor to consider the procedures summarised in the following table:

PROCEDURES	DETAILS
• Basic understanding	• Process flow for investments to identify the risk and control. • Investment policy approved by the investment committee and filed with IRDAI. • Understand the basis/working for segregation of investments in shareholders' funds and policyholders' fund (including discontinued funds) and also with participating and non-participating in policyholder funds.
• Substantive procedures and Test of controls	• Perform walkthrough of the above processes. • Review of concurrent audit reports and investment risk management system and process reports. • Reconcile the holding statement and custodian statement to ensure completeness of book position. • Ensure exposure limits are met- if not, whether the authority had provided relaxation and whether the conditions specified therein have been complied with. • Review the investment policy approved by the investment committee and filed with IRDAI on half yearly basis and all investments are made in line with the investment policy.

	• Ensuring that all the investments are correctly classified and disclosed in the financial statements. • Ensuring that investments are correctly valued. • Ensuring that all the investment functions are In-house except for class of companies exempted by IRDAI (e.g. AUM within certain limits). • Ensuring calculation of NAV of various ULIP schemes are as per IRDAI guidelines. • Ensuring that the company has accounted for all the corporate benefits on timely basis. • Verification of various charges charged to the fund such as fund management charges, guaranteed charges, *etc.* • Obtaining the list of any NPA investments, if any, and the provisioning for the same. • Verification of ULIP disclosures.
• Compliance	• IRDA (Investment) Regulations, 2000 and related circulars. • IRDA (Investment) Amendment Regulations, 2004 for internal control procedures. • IRDA (Investment) (Fourth Amendment) Regulations, 2008. • IRDA (Investment) (Fifth Amendment) Regulations, 2013. • Investment and various other policies. • Filing of investment returns to IRDAI.

Reinsurance Ceded:

It is the process of sharing the risk through sharing the premium. It is important for the auditor to consider the procedures summarised in the following table:

PROCEDURES	DETAILS
• Basic understanding	• Understanding the arrangement with the reinsurers by going through the re-insurance treaties. • Understand the arrangement with reinsurance companies related to profit commission, if any and accounting thereof.
• Substantive procedures and Test of controls	• Verify calculation of premium ceded as per the treaty. • Verify the mortality and other rates being used for calculating the premium is as per the treaty. • Verify the calculation of reinsurer's proportion for the reinsurance claims. • Review the reconciliation between the premium register and premium considered for reinsurance.
• Compliance	• IRDA (Life Insurance - Reinsurance) Regulation 2013. • Reinsurance plan and treaty. • Service tax compliance.

Bank Reconciliation:

Due to large volume of retail transactions, the auditor should be more cautious about bank reconciliation. It is important for the auditor to consider the procedures summarised in the following table:

PROCEDURES	DETAILS
• Basic understanding	• Process of bank reconciliation. • Process of review and monitoring open items in bank reconciliations. • Process of matching the receipts *vis-a-vis* the policy/proposal.
• Substantive procedures and Test of controls	• Obtaining outstanding report from bank and comparison with the items appearing in the BRS representing cheques deposited but not cleared. • Assess the control over all the processes for bank reconciliation. • Verify the long outstanding items pending in bank reconciliation.

Actuarial Valuation:

As per IRDAI Regulations, insurance companies should appoint an actuary, known as "appointed actuary". Insurance reserves certified by the appointed actuary (also known as actuarial reserve) form a significant item of liability in the financial statements of insurance company. An auditor, in his report, state that reliance has been placed on appointed actuary for actuarial valuation of liabilities in their auditors' report. Still, a question arises - can an auditor step in the shoes of actuaries and verify the actuarial reserves? Para A34 to Para A48 of Standard on Auditing 500 - "Audit Evidence" requires an auditor to document the reliability of information produced by management's expert. It is worth taking note that in western world, auditors are expected to validate actuarial valuation by having in-house expert who would conduct peer review of the process and report submitted by the company appointed actuary. The day may not be far when this requirement would also be made applicable in India. It is also important for the auditor to consider the procedures summarised in the following table:

PROCEDURES	DETAILS
• Basic understanding	• Understand the process of calculation of the actuarial liability including fund for future appropriation (FFA). • Assumptions used for calculating the actuarial valuation.
• Substantive procedures and Test of controls	• Validate the inputs/data received from various systems for calculation of actuarial liability. • Review various MIS/data such as death claims, surrender claims, maturity claims, *etc.* and corresponding update of the policy status in data used for valuation. • Review sample policies having specific status based on the file and use documents. • Obtain the list of policies/products which are not considered for actuarial valuation and reasons thereof. • Benchmarking the assumptions used by peer companies.

Certain Matters to be Considered

Apart from the huge volumes and IT complexity, there are various matters which revolve around the insurance industry. Some of these are common across all companies and some arise due to varied practices.

1. ***Accrual of Premium Due and Consequential Actuarial Liabilities on Reporting Period:*** IRDAI has issued a master circular wherein the insurance companies are required to make provisions for policies cancelled during the free look period after the reporting period and correspondingly actuarial valuers are also required to give the effect of the same on actuarial liabilities on basis of certain assumptions and past precedence.

   However, as regards the renewal premium which is accounted for on due basis, the question arises, whether insurance companies can accrue the premium due on reporting period considering the lapsation/persistency ratio? If yes, whether any effect is required to be given on actuarial liabilities on basis of certain assumptions and past precedence, is a matter of debate.
2. ***Contest Payout:*** Insurance companies generally pay incentives in form of contests for achieving business targets, *etc.* other than commission payout. These contests are not linked to any insurance policy. The question arises whether the contest payments which are not linked with any policies, are covered under Section 40A of the Insurance Act, 1938 or not.
3. ***Renewal Commission to Agents:*** Whether insurance companies are liable to pay renewal commission to insurance agents considering Sections 2 (10), 40A, 42 and 44 of the Insurance Act, 1938, even though their license has not been renewed or license has been cancelled, is yet another debatable point.

"It is worth taking note that in western world, auditors are expected to validate actuarial valuation by having in-house expert who would conduct peer review of the process and report submitted by the company appointed actuary. The day may not be far when this requirement would also be made applicable in India."

4. ***Contingent Liabilities:*** Provision and contingent liabilities arising in insurance companies from contracts with policyholders are excluded from scope of AS 29 "Provisions, Contingent Liabilities and Contingent Assets". There are varied practices followed by the insurance companies in terms of disclosure of contingent liabilities especially in litigation cases with existing policyholders / nominees.
5. ***Surrender and Reissuance of Group Policies:*** Corporate clients often switch policies from traditional products to ULIP or *vice versa* depending on the returns given by the insurance companies. Accordingly, switch from original policy is shown under benefit payments and the newly issued policy is disclosed under premium income. The questions remains, what would be the appropriate treatment and whether any disclosure is required to be made in the financial statements?
6. ***Investment in Private Limited Companies in Form of Borrowings:*** Section 27A of the Insurance Act, 1938 clearly disallows investment in shares or debentures of private companies. Whether grant of loan to private companies is also covered or not, is matter of debate.

"IRDAI has issued a master circular wherein the insurance companies are required to make provisions for policies cancelled during the free look period after the reporting period and correspondingly actuarial valuers are also required to give the effect of the same on actuarial liabilities on basis of certain assumptions and past precedence."

Takeaways

Audit of insurance companies is not very different from the audit of other companies. However, there are a few specific points which an auditor needs to take care of. To summarise, there are a few takeaways for auditors:

- Invest more time in planning for identification and assessment of risks and defining the test of controls, analytical and other substantive procedures.
- Reassess and modify the overall audit approach and methodology basis the Guidance Note.
- Comprehensive understanding of the IRDAI regulations and bye-laws.
- Use of modern audit techniques including data analytics through use of audit tools.
- Involve in-house experts (e.g. for information technology and taxation matters).