4.1 MEANING OF PREMIUM

Premium is an amount given by the policy holder to the life insurance company for the risk cover and benefits given by the life insurance company. It may be paid on monthly, quarterly, half-yearly, yearly or as agreed upon. It is the price for an insurance policy.

4.1.1 Types of Premium

According to policy contracts, the life insurance holder chose one of the options to pay the premium. The option can be one of these:

(1) **Single Premium**: In this option, a single amount (one time payment) by the policyholder has to be given to life insurance company, at the beginning of the life insurance contract.

(2) **Regular Premium**: By the agreement of life insurance contract, the policy holder is bound to pay the regular premiums quarterly, half yearly or annually as per the life insurance contract.

(3) **Recurring Single Premium**: The single premium is flexible premium option. The premium can be paid any time whenever the policy holder wants. The time and amount of premium is not predetermined. Most of the pension plans are based on this kind of premium option. So in this single premium option, the life insurance policy can be purchased any time according to the income of a person.
4.2 ACCOUNTING AND ACCEPTANCE PROCEDURE

Every Life Insurance Company shall have to maintain the following books of accounts:

1. Register of Policy Holder
2. Register of Claims
3. Register of License holder Life Insurance Agents

In addition of the above books, the following subsidiary books are also required to be maintained:

1. General Cash Book
2. Patty Cash Book
3. Cash Book of New Premium
4. Cash Book of Renewal Premium
5. Claim Cash Book
6. Journal Proper
7. Agency Debit Journal
8. Agency Credit Journal
9. Proposal Register
10. Commission Book
11. Investment Book
12. General Loan Book
13. Policy Loan Book
14. Lapsed and Cancelled Policies Book

For each life insurance policy, the life insurance companies decide a price which a policy holder (insured) has to pay:

(a) the sum is paid for the life assurance cover
(b) for the expenses of life insurance companies
(c) for the payment of the commission paid to life insurance agents
(d) for the profit of the insurance companies.

While calculating the amount of premium, all the expenses are considered by the life insurance company (a statistician who computes insurance risks and premiums). While calculating the amount of premium of a life insurance policy, the following four factors should be considered:

(i) Mortality Rates
(ii) Investment Income
(iii) Expenses
(iv) Contingency Factor

(i) Mortality Rates

While calculating the amount of life insurance premium of a policy, the mortality tables are referred. These mortality tables are based on statistical calculations. These calculations are considered to calculate the premium. On the basis of these mortality tables, the premium amount is determined and life insurance policies are sold to large number of buyers. Premium is charged on the basis of age, sex and health of a person. The premium amount is increased with the age. The amount of premium is charged differently in each age group and also according to sex. For illustration women have a higher life expectancy as compare to the men, according to the statistical calculations, so the amount of premium is lower for the women.

For example a person of 55 years of age wants to buy a life insurance policy for the period of five years, the premium determined by the life insurance company is Rs. 230/- for the sum assured of Rs. 10,000/-. And if the same life insurance policy is purchased by another person aged 25 years. The premium he has to pay might be Rs. 130/-. Thus the person of 55 years of age will have to pay the high amount of premium for the same policy as compare to the person aged 25 years. If the premium is to be paid annually, the amount of premium will be little lower as compare to the quarterly or half yearly installments of a year. The amount of premium will be increased year by year. If a person buys a life insurance policy when he is on the age
of 25, he has to pay less premium as compare to the amount of premium he has to pay for the same policy which will be purchased by him in future when he will be 55 years old.

Before buying the life insurance policy, the applicant should get medically examined by the authorized doctor of the life insurance company. After getting the medical reports of the applicant, the life insurance companies determines the terms and conditions of the life insurance contract. The premium is determined on the basis of the health status of the applicant.

Thus life assurance companies have generally adopted the practice of writing long-term contracts whereby a level premium is paid throughout the duration of the policy. The premium paid in the early years is, therefore, higher than is needed to cover the cost of a claim in those years. The balance at the end of the year is kept in a fund in order to meet the cost of claims in the later years when the premiums will be lower than required to cover the mortality risk.¹

(ii) **Investment Income**

The amount received as premium by the life insurance companies is invested in various investment options. So the life insurance companies earn the investment income as well. While calculating the premium of a policy, the future possible investment income is also determined by the life insurance companies. The present and future interest rate of returns on investment is considered.

(iii) **Expenses**

While calculating the amount of the premium of a life insurance policy, all the expenses of life insurance company in present and future are considered. These expenses include the commission of life insurance agents, salary of the staff members, brokerage, renewal commission, advertising, initial expenses etc. The

common expenses charged to the life insurance premium. The additional expenses are charged which gives rise to the cost of the life insurance policy.

(iv) Contingency Factor

The factor of contingency is also included in the calculations of the premium of a life insurance policy with the mortality tables, expenses and interest. This includes the situation in which the policyholder can surrender the policy before maturity.

Furthermore, among the above factors, the actuary has to consider these things also:

1. The sum assured of the life insurance policy
2. Age of the insured
3. Lifestyle of the insured
4. Returns on investment in future
5. Level of expenses in future
6. Contingency factor involved in life insurance policy
7. Profit assumed
8. Comparative prices of similar products of other life insurance companies.

4.3 ISSUE OF COVER NOTES AND POLICY

The cover note is a certificate issued by an insurance company stating that a policy is operative. It is used as a temporary measure between the commencement of cover and the issue of the policy. It is a document, evidencing issuance of an insurance policy and gives a summary of the information given in a certificate of insurance.

From above definition, it is clear that a cover note is a temporary insurance’s certificate that is issued by the Insurer before the issuance of a policy after the Insured

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has given a duly filled in proposal form and has paid the premium in full. This note is valid for a period of 60 days from the date of issue of the cover note and the Insurer shall issue the Insurance certificate before the cover note expires.

An insurance cover note is offered by an insurance company to the policy holder or customer that is based on a number of information about the features of an insurance policy and is evidencing the issuance of a particular policy to the policy holder. An insurance cover note is basically based on information including the name of the policy holder, the insured risk, to coverage that is offered by the policy and the total amount of insurance in a brief manner. In many places, an insurance cover note is also known as a certificate of insurance. These notes are usually sent out on the same day the policy is accepted and usually takes about 24 hours in sending out.

An insurance cover note is important enough because it helps in understanding the type and coverage of policyholder’s purchased insurance policy. For example, if anyone wants to purchase a home insurance policy, he has to choose the property protection policy or the home liability insurance. Both policies have their own coverage and charges. An insurance policy cover note also specifies the renewal period or the validity date of an insurance policy. When the specific period of insurance cover notes become close to over, the insurance company then send notification to the policy holder to renew the policy and sent out a new insurance cover note or certificate to the purchaser for the next period of times.

4.3.1 A Sample Insurance Cover Note

<table>
<thead>
<tr>
<th>PRODUCER</th>
<th>This certificate is issued as a matter of information only and conveys no rights upon the certificate holder. This certificate does not amend, extend or alter the coverage afforded by the policies below</th>
</tr>
</thead>
</table>
4.3.2 Coverage

The policies of insurance listed below have been issued to the insured named for the policy period not withstanding, any requirement, term or condition of any contractor or other document with respect to which certificate may be issued or may pertain. The insurance afforded by the policies described herein is subject to alterations and conditions of such policies. Aggregate limits shown may have been reduced by paid claims.

<table>
<thead>
<tr>
<th>S.N.</th>
<th>Type of Insurance</th>
<th>Policy number</th>
<th>Policy effective date</th>
<th>Policy expiry date</th>
<th>Limits</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>X</td>
<td></td>
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<td></td>
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<td></td>
</tr>
</tbody>
</table>
Insurance cover notes are created by the officials of an insurance company and each company has its own format and preferences by writing an insurance cover note. Usually, an insurance cover note is based on the following information.

- Date and information about the company and insured
- Terms regarding an insurance cover note
- Information regarding the type and validity of an insurance policy
• Information about the cancellation of the policy.

4.3.3 Issue of Life Insurance Policy

The process of issuing a life insurance policy is very easy. This involves the following steps:

➢ **Proposal Form Submission:** A person, who wants to purchase a life insurance policy on his life, will have to fill the proposal form issued by the life insurance company. This proposal form contains all the important information about the applicant, such as income, health information, family details, kind of policy required etc. The applicant fills the proposal form and submits it to the life insurance company with all the required documents.

➢ **Agent’s Report Submission:** The life insurance agent has to submit the agent report to the life insurance company, prepared on the basis of proposal form filled by the applicant. This report contains the facts of the enquiry made by the life insurance agent.

➢ **Submission of Doctor’s Report:** The authorized doctor of Life Insurance Company has to submit his report to the life insurance company after the medical examination of the applicant. This report contains all the necessary information about the health of the applicant. This report is a fitness certificate given by the authorized doctor of Life Insurance Company.

➢ **Age Certificate:** The applicant has to submit the age certificate to the life insurance company. Age proof is an essential document required to issue a life insurance policy. The amount of premium of life insurance policy is determined on the basis of age. So the actual age should be disclosed by the applicant with the age proof to the life insurance company.
Scrutiny of Documents: All the documents submitted to the life insurance company for the life insurance policy, are checked by the life insurance company before issuing a life insurance cover to the applicant.

Acceptance of the Proposal: After checking all the documents submitted for the life insurance policy, the life insurance company decides to insure or not to insure the life of the applicant. When the life insurance company finds everything true and fair, the applicant is asked to deposit the premium of the policy. And if in case the proposal is rejected by the life insurance company, a letter of regret is sent to the applicant.

Payment of First Premium: If the proposal is accepted by the life insurance company, the applicant is asked to deposit the first premium. After depositing the first premium by the applicant, the life insurance policy is issued to the applicant by the life insurance company.

4.4 REINSURANCE PRACTICE

In simple words, when an insurance company shares the risk with the other insurance companies or specialist insurance companies, this is called reinsurance. In other words it can be said, when an insurance company reduces the risk by insuring again with other insurance companies, is called the reinsurance. The procedure of accounting of the reinsurance transactions (e.g. Premium paid, Claims reimbursements, Commission paid etc) is actually the spitting image of the direct insurance.

Some of the accounting transactions cause material lags in the reports of losses and premiums, especially those contracts which involves reinsurance pools. Lack of materiality shows false results. When late reported losses and transactions recorded to the correct underwriting year, cause misleading results.
To get the fair reports of reinsurance contracts require insurance companies to make a proper estimate of the losses and premiums which would be reported late. These estimates of losses and premiums become true and actual value when it becomes known to the insurance companies.

4.5 ACCOUNTING FOR PREMIUM

In this chapter, accounting for premium and other incomes have been discussed. The purpose of this discussion is to explain the accounting concepts in recording, summarizing and evaluating the information regarding the premiums, claims etc, for the financial reports of the insurance companies. The accounting for the premium can be classified as follows:

(i) Recognition of revenue

(ii) Written premium mechanism

(iii) Unearned Premium problems

(iv) Unearned premium and loss reserve relations

(i) Recognition of revenue

Premium from the sale of insurance policies is the primary source of income for the insurance companies. Revenue is generally treated as the key analysis factor to measure the growth of the company. As per the accounting standard 9, revenue recognition is the most important element of accounting system. By doing the proper revenue recognition the frauds can be deducted easily and companies can overcome the losses. Recognition of revenue provides the actual results of profitability.

The income from the sales of life insurance policies is the major source of income of life insurance companies. The growth of the life insurance industry is determined by the total revenue earned by the life insurance companies during a
specified time period. These revenue is recognized by the accounting system used by the life insurance companies.

Some factors are considered to recognize the revenue of the life insurance companies which is collected in the form of premium. Those factors are:

- time of signing the life insurance contract
- time when the premium of the policy is due
- time when the premium of the life insurance policy is received
- time when the life insurance policy come into the force
- time when the risk cover factor become effective

In many life insurance companies, the revenue is recognized on the time when the premium of the life insurance policy is due. In this method of accounting the income is determined on the due basis. Some other life insurance companies recognize the income at the time when the risk cover factor is become effective. This kind of accounting method is called deferral-matching approach.

For example, if a life insurance company issues a life insurance policy of premium Rs. 400/- for a year. After three months as one quarter of the insurance policy period is over, only the premium amounting to Rs.100/- will be recognized as revenue for the life insurance company in the deferral-matching approach.

In the deferral-matching method of accounting of premium, the written premiums are utilized. Written premium is the basically is amount of premium charged during a specified period. Any other amount paid earlier of the effective date will not be recognized as revenue for the life insurance company. A liability is made to recognize the revenue from the premium is called unearned premium liability. The liability will decrease by the time of the life insurance policy. So the revenue of the life insurance company for a specified time period is equals to the written premium of that period. In some of the accounting systems, the actual billing of the premium does not affect the income statement and balance sheet.
In the accounting system based on period basis, the unearned premium is recognized to measure the total revenue. While on the other hand, the accounting system not based on the period, unearned premium is not recognized. Ultimate revenue form the premium is equals to the total written premium to the date. Cancellations and late booking are the examples of future written premium transactions.

Other Premium Accounting Approaches

The International Accounting Standards Board (IASB) has issued assets liability approach of accounting for all life insurance companies. The revenue under this method is recognized on the basis of earning on the assets by the life insurance companies. There is no ultimate premium revenue, when the policy becomes effective and full amount of premium is recognized. Assets liability approach is the modern approach of accounting of the life insurance companies.

Earned premium is utilized by these approaches. Therefore, any income statement or other performance measures that rely on earned premium (such as the loss ratio) would need to be adapted to reflect the different premium revenue recognition treatment. Policy or underwriting year concepts may fit this premium accounting approach better than calendar/accident year.³

(ii) Written Premium Mechanism

To measure the growth of the life insurance industry, the term written premium is used commonly by the life insurance companies. To evaluate the growth of the life insurance industry, the understanding of the written premium is required. If this concept of written premium is misunderstood, the whole evaluation of the revenue will be wrong. The amount of the premium of a policy is predefined and fixed when the life insurance policy is sold. The amount of premium never changed during the period of the life insurance policy. So in this case the calculation of the revenue of the life insurance company is easy. The whole amount of life insurance

premium is taken as the amount of revenue. On the basis of the amount of revenue, the growth of the life insurance sector is recognized.

Some difficulty may occur that depart from this easy form. The following are considered as part of premiums:

- **Deposits** – Deposits can be understood as initial deposit amount of the premium. When on the initial stage, the amount of the life insurance premium is not known, the estimated amount deposited in advance as premium, is called the initial deposit. Until the actual premium amount is considered, the deposited amount is considered as the amount of premium.

- **Estimates** – When the amount of premium is not initially known, the amount estimated is deposited as premium of the life insurance policy. The written premium is generally accepted as estimated premium until the actual premium amount is determined. The additional riders of the life insurance policy may increase the amount of the life insurance premium. So the premium amount is estimated on the initial stage.

- **Audits** - In certain cases the exposure pricing may not be ascertained at contract inception, for this the audit is required to find out the final disclosure. The audit is undertaken at the closure or during the term of policy depending upon the base characteristics of disclosure pricing. For example, in case of worker’s compensation policy in which final premium during the policy period is based on the sales insured or payroll respectively, an audit may be required to determine the final premium.

- **Endorsements/cancellations** – The life insurance policy may be canceled during the mid-time of the policy. After purchasing the life insurance policy, if the insured think that the plan is not suitable for his needs and wants or the life insurance agent did not tell him/her all the
important terms of the life insurance policy on which he is not agreed, he/she may apply for the cancellation of the life insurance policy.

The installment premium has not been included in above points. It is because the installment premiums does not affect the billing system of the life insurance premium and does not affect the written premium amount also. The amount of premium which is due but not yet received is called the receivable amount. Those premiums which will be billed in future and not yet due are also called the receivable premium amount. The above mention points may apply to direct insurance as well as to reinsurance contracts. Some other points are also related to premium which may or may not be considered as premium. It depends on the context. These points are:

- **Policyholder dividends** – Dividend is given by the life insurance companies to the policyholder. While calculating the amount of gross income of the life insurance company the dividend amount is also considered in the accounting system. The amount of dividend makes the negative premium for the policyholder.

- **Tax surcharges** – Tax collection is a function of the premium. The insurance companies collect the tax for special purpose. This usually not affects the income statement and balance sheet of the life insurance company. The tax collection may only increase the amount of liability of the life insurance company till the collected tax amount is deposited to the tax authority.

(iii) **Uneearned Premium Issues**

There are two sights for unearned premium: The unearned premium may be viewed as a mirror image of the refund liability at the time of policy cancellation. This can also be viewed as a way to defer the revenue so that the time of revenue will match with the expenses. The above two views may give different values, although such differences are ignored generally. The accounting system clarifies which of the
above view is to be used for unearned premium, as both the views give different values.

**Pro rata approaches (over time):** This revenue deferral view, recognize premiums “as revenue over the period of the contract in proportion to the amount of insurance protection provided”. In general practice, pro-rata over time calculation method is used, in which it is assumed that the protection of insurance is equally spread over the term of the policy.

**Non-pro rata approaches (over time):** All those policies in which the insurance protection is not equally spread over the term of the policy are called non-pro rata approaches (over time). Examples include⁴:

- Policies covering seasonal risks (such as losses from insuring snowmobiles, for which the risk is concentrated in the winter months).
- Aggregate excess policies, covering the risk that total losses over a period are above a certain amount. The risk here is greater towards the end of the policy term than for the beginning.
- Warranty policies, as warranty claims (and mechanical breakdowns) usually increase as the product being warranted ages.
- Financial Guarantee (and other performance bonds), where initial underwriting should make it unlikely for immediate non-performance, resulting in greater likelihood of nonperformance as the contract ages.

It is necessary to calculate non-pro rata earning method for the premium for all those policies, in which the insurance risk is not equally spread over the term of the policy.

As compare to pro-rata approaches, the non pro-rata approaches are more complex. The accounting system allows using simple pro-rata methods for the financial calculations, which are easy to use as compare to the no-pro rata methods.

Earning of deposits, other adjustments: There may be multiple possible approaches for earning items such as deposits, interim audits and other such premium components. Where the accounting system does not dictate the earning approach, the overall goal would normally be to choose an approach that focuses on the total earned premium, with as simple an approach as possible for the pieces that contribute to that total. This may be a function of the individual processing systems and policies that the company uses.5

Premium Deficiency Reserve: As mentioned earlier, one view of the unearned premium reserve is that of deferred revenue. But what if it is determined that the deferred revenue will not be sufficient to cover the corresponding losses and expenses? Most accounting systems require the booking of an additional liability (sometimes called a “premium deficiency reserve”) in such a situation.

The premium deficiency reserve is generally equal to the difference between the losses and expenses expected from the runoff of the unexpired policy term, and the unearned premium liability already held with respect to the unexpired policy term. (The accounting system may or may not also reflect the time value of money in this calculation.) Note that this calculation results in a positive liability only if the unearned premium is not expected to be sufficient to cover the runoff. If this calculation results in a zero or negative value, then no liability is established.6

(iv) Unearned Premium and Loss Reserve Interaction

Losses are only recognized in under the deferral and matching approach. Losses related to the unexpired portion are not covered by the reserves made for losses, it is generally covered by the Unearned Premium Reserve. Deficit in one category can not be compensate with deficit in other category. The deficiency in the reserve for the event, which is not yet happen, should be shown in the unearned premium reserve, while on the other hand any deficiency in the reserves for the event, which is happened, is to be shown in the reserves of losses.

Regular Premiums

The accounting entries to recognize a Rs. 500 renewal premium on a regular premium policy in the month in which the premium falls due would be:

Dr Policyholder/Intermediary Debtor (Balance sheet)       Rs. 500
Cr Premiums Written (Technical Account)         Rs. 500

When the premium will be received by the insurance company, the following entries will be made:

Dr Cash                                        Rs. 500
Cr Policyholder/Intermediary Debtor          Rs. 500

If the policyholder account shows the debit balance, it means the premium of the policy is not received and either the life insurance policy is lapsed or the policyholder has not settled the insurance account yet.

Single Premiums and Initial Premiums

In single premiums and initial premiums, the cash is required at the time when the policy proposal is made. The accounting entry for the same would be:

Dr Cash                                      Rs. 500
Cr Premiums Written                         Rs. 500

The major difference in accounting of life insurance industry and other industries is the accounting of receipt and the payments (Claims). For this the estimate of liability is needed as well as the accounting of solvency and profitability of life insurance business.
4.6 ACCOUNTING FOR OTHER INCOME

Other than the premium income, life insurance companies have some other incomes as well. When the investments are purchased by the life insurance companies, they are shown in the accounting books of such life insurance companies. But year after year the value of these investments is compared with the market value and the adjustments will be required if there is any change in the value of the investments of the life insurance companies.

Return on investment comprises the following:

- Interest and dividends: Interest and dividends are shown as income in the accounting books. At the end of the year the adjustments are made for the income related to the financial year but actually not received.

- Gains and losses arising from changes in the market value of investments: When an investment is sold for a price, which is more than its cost, realized gain is arises. Unrealized gains arise when investments are evaluated to a higher market value at the end of the year but actually not sold. All gains and losses on unit-linked insurance whether realized or unrealized, pass through the ‘life technical account’ and therefore, are reflected in the profit and loss account. Member states may also allow unrealized gains and losses on other life insurance business to pass through the technical account but if the investments are accounted for at cost the market values must be disclosed. In United Kingdom, insurance companies normally show investments at market value in the balance sheet.\(^7\)

A critical phase of investment management is to ensure the matching of investment maturity amount with the claim amount. Earlier the investment management was done by the long term fixed interest investments. In the present scenario the life insurance companies include assets and equity

investments in their portfolios for the investment management to deal with the inflation. It is expected that their values will continue to increase over the long term.