INSURANCE EXAM · IC-26

IC-26 Life Insurance Finance

Revision book

15	2	174
chapters	master tables	numbered sections

FREE SAMPLE: Chapter 1 of 15

CHAPTER 1

Elementary Principles of Accounts

1.1 Process and source documents
1.2 Rules of debit and credit
1.3 Journal
1.4 Ledger
1.5 Cash book
1.6 Trial balance
1.7 Accounting equation
1.8 Final accounts
1.9 Errors

MUST KNOW

1. **Double entry:** every transaction has two effects, one debit and one credit, same amount.
2. **Personal:** debit receiver, credit giver. Real: debit what comes in, credit what goes out. Nominal: debit expenses and losses, credit incomes and gains.
3. Journal = book of prime entry, date order. Ledger = principal book, book of final entries.
4. Ledger debit side uses "To"; credit side uses "By". Each journal entry is posted twice.
5. **Cash book:** cash and bank columns are balanced; discount columns are only totalled. Contra entries are not posted.
6. Discount allowed = expense (debit). Discount received = income (credit).
7. Trial balance checks arithmetic only. It is not a financial statement.
8. Assets = Liabilities + Capital. Profit is added to capital.
9. **Final accounts:** Trading and P&L account + Balance sheet. Loss on assets side; profit on liabilities side.
10. Casting = adding up (over-cast, under-cast). Intentional error = fraud.

1.1 Process and source documents

- **Book-keeping:** records money or money's worth; double entry system
- **Books show:** assets, liabilities, profit or loss, solvency
- **Accounting process:** identify, record, analyse; then financial statements
- Data-source = proof of a transaction (first step)

Transaction	Source document
Purchase of goods or assets	Supplier's invoice
Sale of goods, assets, services	Entity's sales invoice
Return of goods	Debit note (buyer raises); credit note (seller issues)
Cash receipt	Receipt issued by entity

TRAP

A cheque is a mode of payment, not the record of an asset sale.

1.2 Rules of debit and credit

Account	Debit	Credit
Personal	Receiver	Giver
Real	What comes in	What goes out
Nominal	Expenses, losses	Incomes, gains

- **Personal:** capital, drawings, persons, banks. Real: cash, furniture, car. Nominal: purchases, sales, rent, commission
- **Steps:** find two elements; classify; find rule; decide Dr and Cr
- **Credit sale of a computer:** debit buyer, credit computer account

TRAP

Selling a fixed asset: credit the asset account, not sales.

- **Cash paid at time of sale:** no personal account needed

1.3 Journal

- Date, Particulars, Folio, Dr amount, Cr amount
- Dr. = debit; Cr. = credit; line below debit starts with "To"
- Narration = short note, e.g. "Being a car acquired for cash"
- Rectification and closing entries pass through the journal
- **Day-books:** sales, purchases, sales returns, purchases returns, cash book, petty cash book
- Depreciation (non-cash) goes in the journal

FORMULA AND WORKED SUM

- **Opening entry:** Capital = Assets - Creditors; e.g. 2,00,000 - 90,000 = 1,10,000

1.4 Ledger

- Principal book; book of final entries
- Folio = page number of journal or subsidiary book
- **Posting is done twice:** debit side of one account, credit side of the other
- **Subsidiary books:** cash book, purchase book, sales book
- Casting and balancing must be exact (final accounts rest on them)

1.5 Cash book

- Receipts side (left) = debit; payments side (right) = credit
- **Cash and bank columns act as ledger accounts:** no second posting, balanced, go to trial balance

Event	Cash	Bank
Cash deposited in bank	Payment	Receipt
Cash withdrawn from bank	Receipt	Payment

- **Both are contra entries:** not posted
- **Discount columns:** totalled, not balanced; totals posted to ledger

FORMULA AND WORKED SUM

- **Full settlement:** 25,000 - 24,700 = 300 discount allowed (Dr)
- **Cash book sample:** discount allowed 900, discount received 200, cash 3,000, bank 4,000

TRAP

Discount columns are not ledger accounts.

1.6 Trial balance

- Summary of ledger balances at a date; total Dr = total Cr
- A statement, not a ledger account; not part of financial statements
- **Purpose:** arithmetical accuracy; help find errors; base for statements
- Tally = only preliminary assurance
- **Steps:** balance accounts; total debtors and creditors into one figure each; list; total columns
- Expense and income balances go to P&L; asset and liability balances to balance sheet

TRAP

Equal totals do not prove books are right.

1.7 Accounting equation

FORMULA AND WORKED SUM

- Assets = Liabilities + Capital
- Capital = Assets - Liabilities
- Liabilities = Assets - Capital

- **Assets:** debit balances; liabilities and capital: credit balances
- Profit added to capital; capital and profit are owed to owner

FORMULA AND WORKED SUM

- **Elite Traders:** cash 50,000 - 15,000 - 30,000 + 20,000 = 25,000; profit 5,000; assets 55,000 = capital 50,000 + profit 5,000
- Liabilities 30,000 + capital 70,000 = assets 1,00,000

1.8 Final accounts

- **Trading and P&L account:** profit or loss for the period
- **Balance sheet:** position at end (what is owned, what is owed)
- **Nominal accounts to P&L:** expenses and losses debit; incomes and gains credit
- Loss to assets side; profit to liabilities side
- Credit balances left (capital, liabilities); debit balances right (assets)

FORMULA AND WORKED SUM

- **Mr Kapoor:** profit = 2,350 - (2,000 - 200) - 120 = 430; assets 6,230 = 5,000 + 430 + 800

1.9 Errors

- Error = accidental; intentional = fraud
- Trial balance may agree and still hide errors

Stage	Errors
Recording	Principle, omission, commission
Posting	Omission, wrong account, side, amount
Balancing	Wrong totalling or balancing
Trial balance	Wrong amount, account, side

- **Casting error:** over-casting (more than true), under-casting (less)
- **Posting errors:** wrong amount (transposition = digits swapped); omission; wrong side
- **Wrong carry-over:** correct ledger balance copied wrongly to trial balance

FORMULA AND WORKED SUM

- Sales 10,000 + 25,000 + 15,000 = 50,000; total of 40,000 = under-cast by 10,000

CHAPTER 1 (CONTD.)

Elementary Principles of Accounts

1.1	Errors and the trial balance	1.2	Capital and revenue
1.3	Trading Account	1.4	Profit and Loss Account
1.5	Year-end adjustments	1.6	Balance Sheet
1.7	Partnership worked example (31 Dec 2015)	1.8	Receipts and Payments Account

MUST KNOW

1. **Errors that break the trial balance:** wrong one-sided amount, transposition (gap divisible by 9)
2. **Six errors that do NOT break it:** omission, commission, principle, compensating, prime entry, complete reversal
3. Capital items go to the Balance Sheet; revenue items go to the Profit and Loss Account
4. Gross profit = Net sales - Cost of goods sold; then net profit after all other items
5. **Four year-end adjustments:** outstanding expense, prepaid expense, accrued income, income received in advance; all reversed on day 1 of next year
6. Balance sheet is as on a date; liquidity order and permanence order are broadly opposite; same order for both sides
7. Receipts and Payments Account = cash system of non-profit bodies

1.1 Errors and the trial balance

Breaks the trial balance	Does not break it
- **Wrong amount on one side**	Omission (left out fully)
- **Transposition (digits swapped)**	Commission (wrong account or amount, right side)
-	Principle (asset treated as expense)
-	Compensating (two errors cancel)
-	Prime entry (wrong figure in book of prime entry)
-	Complete reversal (Dr and Cr swapped)

FORMULA AND WORKED SUM

- **Transposition gap divides by 9:** 5,100 vs 1,500 = 3,600 (/9 = 400); 5,200 vs 2,500 = 2,700 (/9 = 300)
- **Wrong one-sided amount:** 900 - 500 = 400 gap

- **Steps to find:** re-add totals; include cash and bank; look for item = half the gap (wrong side); gap divisible by 9 = transposition; re-add books; verify brought-down balances and postings
- **Match:** casting (sales book total wrong); omission (return not entered); posting (72,735 as 72,375); principle (machinery in Purchases)

TRAP

- A car bought and debited to Purchases is an error of principle; trial balance still agrees; profit and assets both too low
- Half the gap = wrong-side posting; not a transposition

1.2 Capital and revenue

- Capital = assets of useful life at least **1 year**; revenue = day-to-day income and expense

Item	Class
- Capital expenditure	Benefit over more than one period; raises value or life of asset
- Capital receipt	Sale of non-current asset, share capital, loans, debentures, share premium
- Revenue expense	Keeps existing capacity; benefit current (repairs, consumables, power)
- Revenue receipt	Regular income: sales, rent, commission

- **Capital expenditure includes:** asset purchase, carriage inward, stamp duty, registration, legal and architect fees, installation, improvement
- Capitalisation = expense added to cost of asset
- **Deferred revenue expense:** benefit 2 or more years (publicity, preliminary, R and D); write off over 2+ years; unwritten part is an asset

FORMULA AND WORKED SUM

- Land 9,00,000 + stamp duty 50,000 = 9,50,000 cost
- Computer 25,000 capital; stationery 250 revenue

TRAP

- **Same article:** stock for a dealer (revenue), asset when used in shop (capital)
- Capital receipt has no direct bearing on profit; revenue receipt links to profit

1.3 Trading Account

FORMULA AND WORKED SUM

- Gross profit = Net sales - Cost of goods sold
- Trader cost of sales = Opening stock + Purchases - Closing stock + costs to bring goods in (freight, duty, octroi)
- **Manufacturer:** also wages, fuel and power, factory costs
- 20,000 + 90,000 + 2,000 - 12,000 = 1,00,000; GP = 1,40,000 - 1,00,000 = 40,000 (28.6%)

- Credit bigger = gross profit; debit bigger = gross loss
- **Causes of falling GP percentage:** high material cost, wastage, inefficiency, lower prices or sales, wrong stock value

TRAP

Carriage inward and factory lighting = Trading; carriage outward and other lighting = Profit and Loss

1.4 Profit and Loss Account

Item	Treatment
- Drawings	Debit Capital Account; not an expense
- Owner's income tax	Debit Drawings
- Deferred revenue expense	This year's share to P and L; rest an asset
- Prepaid expense	Asset; reverse next year
- Outstanding expense	Liability; reverse next year

- **Debit items:** salaries, rent and rates, insurance, advertising, freight on sales, bad debts, provision, travelling, royalties, commission, repairs, depreciation, loss on sale, telephone, printing, bank charges, interest paid, audit fees, fire loss
- **Credit items:** discount received, commission earned, interest, dividend, rent received, bad debts recovered, profit on sale of assets

1.5 Year-end adjustments

Adjustment	Profit	Shown as
- Outstanding expense	Falls	Current liability
- Prepaid expense	Rises	Current asset
- Accrued income	Rises	Current asset
- Income received in advance	Falls	Current liability

FORMULA AND WORKED SUM

- **Outstanding interest:** 10,00,000 x 9% x 3/12 = 22,500 (loan 1 Jan 2015, year end 31 Mar 2015)
- **Next year charge:** 90,000 + 22,500 - 22,500 = 90,000
- **Practice:** 6,000 x 3/6 = 3,000 accrued
- Insurance 24,000 from 1 Nov; year end 31 Dec: expense 2/12 = 4,000; prepaid 10/12 = 20,000
- Rent 400 x 3 = 1,200 accrued; income 3,600 + 1,200 = 4,800; next year 6,000 - 1,200 = 4,800
- Fee 10,000; half work done: 5,000 income, 5,000 in advance

TRAP

Money received in advance is not income yet; money paid in advance is not an expense yet

1.6 Balance Sheet

- As on a date; Assets = Liabilities + Capital; made after Trading and P and L Account
- **Liquidity order:** cash first ... goodwill last; Permanence order: goodwill first ... cash last (broadly opposite)
- **Liabilities:** order of urgency, capital last (non-company firms); same order as assets
- **Companies:** Schedule III of Companies Act **2013**; partnerships: realisability and payment order; banks: most liquid first
- L.I.C. followed fixed assets first (history)

TODAY'S RULE

Insurers now: IRDAI (Actuarial, Finance and Investment Functions of Insurers) Regulations **2024** replace the **2002** Financial Statements regulations; **2024** Master Circular gives detail

TRAP

Profit and Loss Account and Balance Sheet depend on each other

1.7 Partnership worked example (31 Dec 2015)

FORMULA AND WORKED SUM

- Net sales 3,52,690; net purchases 1,65,700; cost of sales 2,14,510
- Gross profit 1,38,180; expenses 99,350; net profit 38,830
- Depreciation 8,540 + 270 + 600 + 4,290 = 13,700
- Provision 5% x 1,08,600 = 5,430; loan interest 20,000 x 5% x 6/12 = 500
- Interest on capital 7,500 (A) and 2,500 (B); B salary 3,000
- Divisible profit 38,830 - 3,000 - 10,000 = 25,830
- Balance sheet total 2,82,710

TRAP

Drawings reduce capital; salary and interest on capital are appropriations

1.8 Receipts and Payments Account

- Cash system of non-profit bodies; treasurer's account
- **Four parts:** opening cash and bank; actual receipts; actual payments; closing cash and bank

TRAP

Only cash items; no outstanding, prepaid or accrued amounts

CHAPTER 1 (CONTD.)

Accounts of Non-trading Bodies, Depreciation, Provisions, Bank Reconciliation

1.1 Non-trading accounts
1.2 Depreciation
1.3 Provisions and reserves
1.4 Bank reconciliation
1.5 Cheques cancelled
1.6 Other

MUST KNOW

1. Receipts and Payments A/c = cash summary; capital + revenue; no surplus.
2. Income and Expenditure A/c = accrual, revenue only; surplus adds to capital fund.
3. Depreciation = (cost - residual) spread over life; matching principle.
4. Diminishing balance and sum of years' digits are accelerated methods.
5. **Sinking fund:** invest at year end; insurance policy: premium at start of year.
6. Provision = liability/fall in value; reserve = out of profit.
7. **Cash book higher:** uncredited deposits, bank charges, standing orders, dishonoured cheques.
8. **Cash book lower:** unpresented cheques, interest, direct credits.
9. **Current insurer rule:** Actuarial, Finance and Investment Functions of Insurers Regs 2024 + 2024 Master Circular.

1.1 Non-trading accounts

Point	Receipts and Payments	Income and Expenditure
Basis	Cash	Accrual
Items	Capital and revenue	Revenue only
Opening cash	Shown	Not shown
Result	Closing cash	Surplus or deficit

- Receipts on debit, payments on credit (R and P).
- Income on credit, expenditure on debit (I and E).
- Surplus added to capital fund; deficit deducted.

TRAP

Earlier-period subscriptions appear in R and P, not in I and E.

1.2 Depreciation

- **Causes:** wear and tear, time, obsolescence, exhaustion.

- Salvage value = amount expected on disposal at end of life.
- Provision for depreciation is over and above repairs.

FORMULA AND WORKED SUM

- **Straight line:** (cost + fitting - residual) / life. Rs 4,80,000 - 20,000, 8 years = 57,500.
- **Diminishing balance:** % on W.D.V. Rs 50,000 at 20%: 10,000 / 8,000 / 6,400.
- **SYD:** life 4 -> 10 digits; year 2 = 3/10 x 90,000 = 27,000.
- **Sinking fund:** 70,000 yearly at 5%: year-3 interest 7,175.
- **Insurance policy:** 17,500 x 5 = 87,500; excess over 1,00,000 = 12,500.
- **Production hours:** 6,00,000 / 50,000 = 12 per hour; 4,000 hours = 48,000.
- **Gain on sale:** sale price - book value. 1,20,000 - 1,05,000 = 15,000.

- **Annuity:** leases; interest allowed for; fixed yearly write-off.
- **Sinking fund accounts:** Machine, Depreciation Fund, Fund Investment, Depreciation.

TRAP

- **Sinking fund:** asset stays at cost; fund account closes it.
- Insurance policy suits vehicles with uncertain life.

- **Life assurers:** depreciation is an expense; under the **2002** regulations (now replaced) house property depreciation was shown as a reserve on the liabilities side.

TODAY'S RULE

Insurer reporting: Actuarial, Finance and Investment Functions of Insurers Regs **2024** (older: Financial Statements Regs **2002**).

1.3 Provisions and reserves

- **Doubtful debts:** Bad debts Dr; To Provision. Bad later: Provision Dr; To Debtors.
- Debtors shown net of the provision.

FORMULA AND WORKED SUM

- **Part recovery:** 40,000 x 30% = 12,000 cash; loss 28,000.

TRAP

Excess provision may become a reserve.

1.4 Bank reconciliation

Item	Cash book vs pass book
Uncredited deposit	Cash book higher
Unpresented cheque	Cash book lower
Bank charges	Cash book higher
Standing order	Cash book higher
Dishonoured cheque	Cash book higher
Interest credited	Cash book lower
Direct credit	Cash book lower

FORMULA AND WORKED SUM

- **From cash book:** add unpresented, interest; deduct uncredited deposits, charges. 12,400 -> 13,280.
- **From pass book:** add deposits not cleared, standing orders; deduct unpresented, direct credits. 9,800 -> 8,100.

- Fix cash book errors first; then reconcile.
- Favourable balance = credit side higher; overdraft = debit side higher.

TRAP

- Issued and presented cheque = no difference.
- Unpresented cheque is not a pass-book item.

1.5 Cheques cancelled

- Stale cheques generally not honoured.
- **Cheque validity under RBI rules:** **3 months** from its date (since **1 April 2012**).
- **Cancel:** Bank Dr; To Cheques Cancelled. Fresh: Cheques Cancelled Dr; To Bank.
- Cancelled in credit column of register; fresh payment in debit column.
- Indemnity bond if party says cheque not received in time.

1.6 Other

- Trial balance checks arithmetical accuracy.
- Discount allowed = nominal; cash, bank, stock, furniture = real.
- Purchases debit; sales, rent received, share premium, accumulated depreciation credit.

TRAP

Prepaid expense = asset; income received in advance = liability.

FORMULA AND WORKED SUM

- **Receivables:** 20,000 + 5,00,000 - 4,000 - 4,50,000 = 66,000 (cash sales excluded).