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STATEMENT OF RECOMMENDED PRACTICE ON ACCOUNTING FOR INSURANCE BUSINESS

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PART 1 Explanatory Note

1.1. Background

The Association of British Insurers has agreed to develop an industry statement of recommended practice (SORP) on accounting for insurance business. This is intended to apply to all enterprises underwriting insurance business in the United Kingdom but not to Lloyd's syndicates. In developing this SORP it is intended to deal with the following features which are unique to insurance business namely premiums, expenses, claims and unexpired risks. At a later stage other features will be dealt with which, although not unique to insurance business, require separate consideration to take account of the special characteristics of insurance business, e.g. investments. In developing the recommended practice outlined in this SORP it is relevant to establish the framework within which financial reporting by insurance enterprises operates. This is derived from five sources:

(i) Statutory company requirements - Companies Act 1985

(ii) Statutory insurance supervisory requirements - Insurance Companies Act 1982.

(iii) Statements of standard accounting practice (SSAPs)

(iv) Requirements of UK Stock Exchange

(v) Insurance industry practice.

The statutory company requirements provide the legal framework within which the form and content of the annual shareholders' and members' financial statements must be prepared. These are framed on a "true and fair" basis (see paragraph 1.6.) and would normally regard enterprises as "going concerns" (see paragraph 1.7.4).

The insurance supervisory legislation provides the legal framework for statutory returns to the supervisory authorities on a somewhat different basis for that required by the Companies Act 1985.

The SORP is intended to apply only to the financial statements prepared in accordance with the requirements of the Companies Act 1985 and not to the statutory returns to the supervisory authorities although indirectly it will have effect as regards the valuation of liabilties. Nor will it apply to returns made to the fiscal authorities which, although based on the financial statements, may differ from the financial statements due to taxation legislation and current taxing practice.

SSAPs may be regarded as supplementing statutory requirements and are applicable to enterprises generally. Enterprises are expected to follow SSAPs or to disclose the reason for not so doing. Failure to give a reason for non-compliance normally results in the auditor referring to the non-compliance in his audit report. Where compliance with the requirements of a SSAP would result in a conflict with any statutory exemptions from disclosure under the Companies Act which have been utilised, the requirements of the SSAP need not be followed. The requirements of the UK Stock Exchange, modified to reflect the special characteristics of insurance business, are applicable only to companies whose securities are listed on the Stock Exchange and are mandatory.

Insurance industry current practice has evolved to provide a practical basis of financial reporting within the statutory and mandatory requirements. Such practice has no legal effect but is evidence of what is regarded as generally accepted practice within the industry.

The EEC has recognised the need for special accounting rules for insurance enterprises by excluding them from the fourth directive (78/660/EEC) and setting in motion work aimed at producing a separate insurance accounting directive.

The introduction of a non-mandatory SORP provides an opportunity to develop present industry practice on a basis which should command general support, and which in turn should influence the preparation of the EEC insurance accounting directive.

1.2 The business of insurance

1.2.1 The primary purpose of all types of insurance is to provide financial protection to the owner of an insurance policy or contract from identified risks occurring within a specified period in consideration for the payment of a premium.

1.2.2 The risks underwritten fall into two areas, those mainly associated with the expectation of life (see paragraph 2.12), which are referred to as life business or long-term business, and the rest, which are referred to as non-life business or general business.

1.2.3 All types of insurance business may be subject to reinsurance, which is the placing of certain of the risks underwritten by an insurer in order to reduce the insurer's exposure to those risks.

1.2.4 Inherent in insurance operations is the fact that income in the form of premiums is normally received or receivable in advance of expenditure relating to that income and this creates a circulating fund available for investment. The resulting investment income together with increases/decreases in the value of the investments representing the circulating fund play an important part in an insurance enterprise's operations, as does also the stewardship of the policyholders' and shareholders' funds and the requirement to maintain a suitable margin of solvency.

1.2.5 For general insurance business the liabilities of the policies or contracts arise as a result of the occurrence of a claim and are calculated by the enterprise using all available data and techniques.

1.2.6 For long-term business, the liabilities of policies or contracts are determinable as from the outset and must be valued, so that the adequacy of assets may be demonstrated, and the amount of the surplus of assets over liabilities identified. The Board of Directors is ultimately responsible for the financial statements but the valuation of the liabilities under long-term business policies or contracts, which are covered in the long-term business funds in the financial statements, are the responsibility of the appointed actuary. He is also required to consider the suitability of the assets for the liabilities assumed.

In determining both the liabilities under long-term business policies or contracts and the surplus and in recommending the distribution of the surplus the appointed actuary complies with current legislation and guidance issued by the actuarial profession in conjunction with its memorandum on professional conduct and practice.

In a long-term business enterprise the appointed actuary has a statutory role. There is no equivalent statutory role in a general business enterprise.

1.3. <u>Distinction between insurance and manufacturing enterprises</u>

1.3.1 A distinction can be drawn between the preparation of a set of financial statements of a manufacturing enterprise and that of an insurance enterprise. Whereas in the former there is less emphasis on estimation both on the cost side and on the sales side, with an insurance enterprise the price of its products is fixed and sales are contracted before, and sometimes a long time before, it has settled its cost of production i.e. claims. A large degree of estimation must be employed in order to calculate the expected cost of claims in the period between their occurrence and settlement before a result can be determined. These estimations must be reasonable, logical and consistent and must follow basic accounting concepts.

1.4. <u>Objective of paper</u>

1.4.1 The objective of this paper is to discuss, develop and set out recommended accounting practice for the insurance industry in the following four areas.

(i) Premium income,
(ii) Expenses with special reference to acquisition expenses,
(iii) Claims including payments to long-term business policyholders, and related expenses, arising from insurance contracts as regards insurers, and
(iv) Unexpired risks.

1.5. <u>Accounting for insurance</u>

1.5.1 Basically there are two types of insurance business, general business and long-term business, which are accounted for either on an annual basis or on a fund accounting basis. There is also a modification to the annual accounting basis called the deferred annual accounting basis.

1.5.2 An annual accounting basis is one where credible estimates are used to enable a result to be determined at the end of each accounting period in respect of insurance on risks in force during that period. Most classes of general insurance business utilise this basis.

1.5.3. For some classes of reinsurance business it is not possible to obtain the necessary data to make credible estimates to determine a result at the end of the current accounting period but more information of sufficient accuracy is available subsequently which permits a result to be determined at the end of the following accounting period. In these circumstances the deferred annual accounting basis should be utilised. The balance remaining at the end of the current accounting period (open year) will represent income and outgo recorded to date augmented by any provisions for anticipated deficiencies.

The underwriting result disclosed in the financial statements for an accounting period will comprise the result for the year being closed at the end of the current accounting period, less any provision made in the prior accounting period, together with any provision made in the current accounting period for the year which is still open.

1.5.4 With general insurance business where even by the end of the following accounting period a considerable level of estimation would be required to determine a result as, for example, in the case of marine, aviation and transport business and non-proportional reinsurance, the fund accounting basis is used. All premiums written less claims and expenses paid are carried forward until a result is determined usually at the end of three or more years after the commencement of the underwriting year. Although recognition of profit is delayed where this basis is adopted, the prudence concept (see paragraph 1.7.7) requires that any anticipated eventual loss should be recognised in the financial statements as soon as practicable. As with the deferred annual basis the balance remaining at the end of the open year or years represents income and outgo recorded to date augmented by any provisions for anticipated deficiencies.

The general insurance underwriting result disclosed in the financial statements for an accounting period will comprise the result for the underwriting year closed at the end of that period, less any provisions made in earlier accounting periods, together with any provisions made during the accounting period for those underwriting years still regarded as open.

The fund accounting basis is also used for all long-term business. Premiums, investment income, claims, expenses and other relevant income and outgo items are recorded in the revenue account. The balance at the end of the accounting period which is called the fund is tested for adequacy by comparing it with the actuary's estimated valuation of liabilities (see paragraph 1.2.6). This comparison is made at the end of a predetermined valuation period. Any surplus emerging may then be distributed to policyholders and, if applicable, to shareholders.

1.5.5 Reinsurance or cession of insurance business does not in any way reduce an enterprise's primary obligations to its policyholders or ceding companies. It will only be possible to show a complete picture of an enterprise's activities in the financial statements where reinsurance arrangements are significant if the effect of those arrangements on premiums and claims is disclosed. Non disclosure would in certain circumstances, give a misleading impression as to the extent of the enterprise's overall operations.

1.5.6 As a general rule within an enterprise's records the accounting treatment of outwards reinsurance should follow the accounting treatment of the direct or inwards business being reinsured.

1.6 True and fair view

For all insurance enterprises the financial statements must be drawn up to show a true and fair view of the state of affairs of the enterprise taking account of current legislation and relevant SSAPs. Under the provisions of the Companies Act 1985 paragraph 28(2) of Schedule 9 the financial statements will be regarded as showing a true and fair view despite the fact that certain statutory disclosure exemptions available have been utilised. These exemptions if utilised override the requirements of any SSAPs. Increasingly insurance enterprises are not availing themselves of these exemptions.

1.7. Accounting concepts

1.7.1 In recording the insurance operations and preparing periodic financial statements four fundamental accounting concepts should be embraced. These as defined in SSAP 2 paragraph 14, are

(i) "going concern"
(ii) "accruals (or matching)"
(iii) "consistency"
(iv) "prudence".

1.7.2 Because of their general nature it is presumed that the four fundamental accounting concepts have been observed in the preparation of a set of financial statements. If this is not the case then appropriate disclosure must be made.

1.7.3 The four fundamental accounting concepts referred in SSAP 2 do not have an established relationship with one another. Their relative importance will vary according to the circumstances. For general business and long-term business accounted for on a basis other than an annual basis, the prudence concept assumes greater importance whilst the accruals concept is less important. SSAP 2 states that when the accruals concept is incompatible with the prudence concept, the latter prevails.

1.7.4 The Going Concern Concept:

This presumes that the enterprise will continue to operate for the foreseeable future with no prospect of having either substantially to reduce the scale of operations or to liquidate the enterprise. In the event that this assumption is not justified appropriate disclosure is required and the basis on which the financial statements are prepared will need to be changed accordingly.

1.7.5 The Accruals Concept:

This presumes that revenue and costs are recognised as they are earned or incurred, rather than when they are received or paid. It also presumes that revenue and costs are matched as far as practicable and dealt with in the accounting period to which they relate.

1.7.6 The Consistency Concept:

This presumes that there is consistency of accounting treatment of like items within each accounting period and from one period to the next. It does not mean that, once adopted, such treatment must be adopted indefinitely. Any change in accounting policy will require disclosure and, if significant a quantification of the change.

Whilst this concept does not give rise to any problems unique to the insurance industry it does imply the need to disclose any material changes in, for example, the factors underlying the calculation of outstanding liabilities in general insurance business.

1.7.7 The Prudence Concept:

This presumes that revenue and profits are not anticipated until they have been realised either in cash or in some form of asset where the realisable amount can be established with reasonable certainty.

It also presumes that provision is made for all liabilities, whether known for certain or whether they can be reasonably estimated from the information available at the time. The prudence concept does not require the taking of precautionary 'margins' in the estimation of liabilities.

1.8 Premiums, claims and expenses

In this paper and unless the text requires otherwise all references to premiums, claims and expenses are to be taken as the gross amounts, i.e. before any deductions for reinsurances or retrocessions.

1.9 Materiality

In common with SSAPs the recommendations in this SORP as to accounting practices and disclosure are the minimum deemed necessary and are not intended to apply to immaterial items.

PART 2 - Definition of Terms

2.1.	Accounting Period	A period in respect of which a revenue account and/or a profit and loss account is made up.
2.2.	Acquisition expenses	For general business all expenses that vary with and are primarily related to the acquisition of new insurance contracts and the renewal of existing insurance contracts. For long-term business all expenses that vary with and are primarily related to the acquisition of new insurance contracts.
2.3.	Claim:	A claim means a claim against an insurance enterprise under a contract of insurance. A claim arises from the occurrence of an insured event, such as death or disability of the insured; the maturity of an endowment policy; the destruction or damage of property and related death or injuries; the incurring of hospital or medical bills or the attainment of pensionable age, and in the case of long-term business includes the amount payable on the surrender of a policy.
2.4.	Co-insurance:	Where two or more insurance enterprises accept a risk in agreed proportions and each insurer is primarily responsible for its own portion.
2.5.	Direct business:	All business where the insurer accepts primary responsibility, including co-insurance business.
2.6.	General business premiums	The charges excluding any premium taxes made by the enterprise in return for underwriting a risk.
2.7.	General insurance business:	Insurance operations other than long-term insurance business.
2.8.	Inception of risk: (General business only)	A policy or contract of insurance incepts when the liability to risk of an insurer commences and, for this purpose, a policy or contract providing permanent open cover is deemed to commence on each anniversary date of the contract.
2.9.	Indirect business:	Business accepted as a result of a reinsurance agreement.
2.10.	Investment income:	Interest, royalties, dividends and rentals received or receivable less expenses incurred in achieving that income (excluding expenses of a capital nature) and interest payable.
2.11.	Long-term business premiums:	The charges made by the enterprise to meet the liabilities under its in force contracts on the basis of assumptions with respect to mortality, disability, investment return, withdrawals, expenses, surplus and shareholders' profit (where applicable).

2.12. Long-term insurance business:	Insurance operations primarily concerned with survival to a stipulated age or on death only. Such risks insured are predominantly death, disability and pension business, but also include permanent health and capital redemption business.
2.13. Maintenance expenses (long-term business only)	Expenses that primarily relate to the maintenance and renewal of existing insurance contracts.
2.14. Non-proportional reinsurance:	The reinsurer accepts liability for losses incurred by the reinsured in excess of an agreed amount normally subject to an upper limit.
2.15 Premiums written	The aggregate of premiums due for the accounting period before any adjustments for opening and closing provisions for unearned premiums.
2.16. Proportional reinsurance:	The reinsurer accepts liability for a proportion of each loss incurred by the reinsured in return for the same proportion of the original premium, less commission.
2.17. Reinsurance inwards and outwards	Reinsurance may be on the basis of individual risks (facultative) or particular classes of business (treaty). The placing of the risks is known as reinsurance outwards and the enterprise involved as the cedant while the acceptance of the risks is known as reinsurance inwards and the enterprise involved as the reinsurer. Where the reinsurance consists of the placing of inwards reinsurance which the cedant has already received, it is known as retrocession and the recipient as the retrocessionaire.
2.18. Revenue account	An account which shows a financial summary of the insurance related inflows and outflows adjusted for opening and closing provisions.
2.19. Underwriting year:	The underwriting year normally means the accounting period in which the contract commenced.

PART 3 - Summary of Recommended Practice

3.1 General business accounting practice - premiums

3.1.1 All premiums are to be recorded in the accounting period in which they incept. (4.1.1)

3.1.2 An estimate of pipeline premiums is to be included. (4.1.1)

3.1.3 When an enterprise uses the "pre debit" method of accounting lapses are to be estimated. (4.1.1)

3.1.4 If an enterprise receives premiums by instalments then the total premium is to be recorded. (4.1.1)

3.1.5 Portfolio premiums are to be included with premiums. (4.1.1)

3.1.6 Where premiums are received after deduction of commissions then the premiums are to be shown gross. (4.1.1)

3.1.7 Adjustments for reductions in premiums are to be recorded as soon as they can be foreseen. Increases in already recorded premiums are only to be recorded when the increases are known with reasonable certainty. (4.1.2)

3.1.8 The calculation of the unearned premium provision is to be on a time apportionment basis unless, due to the uneveness of the risk, a more appropriate method can be used. (4.1.3)

3.1.9 The unearned premium provision is to be shown before any deductions are made for deferred acquisition expenses. (4.1.5)

3.1.10 All outwards reinsurance premiums are to be recorded in the same accounting period as the premiums for the corresponding direct or inwards reinsurance business being reinsured. (4.5.1.)

3.1.11 All premiums are to be shown gross. Reinsurance premiums ceded are to be separately disclosed. (4.5.2)

3.2. General business accounting practice - expenses

3.2.1 A clear distinction is to be made between capital and revenue expenses by means of an internal classification. (5.1.2)

3.2.2 Expenses are to be recorded on an incurred basis. (5.1.6)

3.2.3 Under the annual or deferred annual accounting basis, expenses attributable to underwriting activities should be charged against income over the same period as the premiums are credited as earned. (5.2.1).

3.2.4 An accurate method of calculating deferred acquisition expenses should be adopted; with the possible exception of proportional reinsurance business, the straight percentage method is unacceptable. (5.2.2)

3.2.5 Under the annual or deferred annual accounting basis expenses attributable to the claims activity should be charged in full against income of the accounting period in which they are incurred. (5.2.5).

3.2.6 Under the fund accounting basis expenses should be charged in the accounting period in which they are paid (5.3.1).

3.2.7 Expenses attributable to the investment activities should be charged against investment income. (5.5)

3.2.8 Corporate activity expenses should be charged either to the revenue account or to the profit and loss account as considered to be appropriate by the enterprise. (5.6)

3.2.9 The individual enterprise should decide in accordance with generally accepted accounting practice what constitutes expenditure of a capital nature and how the expenditure will be treated for amortisation purposes. (5.7)

3.3 General business accounting practice - claims

3.3.1 Full provision is to be made for all claims outstanding whether notified or not and related claims handling expenses. (6.2, 6.3)

3.3.2 Amounts recoverable for salvage and subrogation are to be deducted from claims outstanding. (6.1.5)

3.3.3 When assessing the amounts recoverable under reinsurance claims the security of the reinsurer is to be considered. (6.1.5)

3.3.4 Cross funding as an accounting practice is unacceptable (6.4.4).

3.3.5 Transfers are permitted between different classes of business within the same underwriting year provided that the classes are managed together and accounted for in the financial statements as one fund. (6.4.6)

3.3.6 It is permissible to return to the source of origin a "top up" transfer if it is shown that the transfer is not required. (6.4.7)

3.3.7 All claims are to be shown gross. Reinsurance recoveries are to be separately disclosed. (6.7.1)

3.4 General business accounting practice - unexpired risks

3.4.1 The general financial position of the enterprise is to be taken into account when assessing the need for an unexpired risks provision. (7.1)

3.4.2 Full provision is to be made for unexpired risks with a separate carry forward of deferred acquisition expenses. (7.3)

3.5 General business accounting practice - discounting

3.5.1 Explicit discounting of certain outstanding claims is permissible but implicit discounting is not acceptable. (8.3.1)

3.5.2 A conservative rate for discounting should be used. (8.3.2)

3.5.3 A portion of the gross investment income is to be credited to the revenue account. (8.3.3)

3.6 General business disclosure

The following should be disclosed:-

3.6.1 The accounting policy adopted for premium recognition and the provision for unearned premiums. (4.6.1)

3.6.2 The classes for which a fund accounting basis is used and the time deferral to profit recognition. (4.6.2)

3.6.3 An analysis of net premium income. (4.6.3)

3.6.4 The deferred expenses accrual together with the amount of deferred expenses carried forward. (5.2.3)

3.6.5 The net change in deferred acquisition expenses is to be treated as a disclosed adjustment. (5.2.4)

3.6.6 The policy adopted for capitalising expenditure. (5.8)

3.6.7 The accounting policies adopted for claims recognition. (6.8.1)

3.6.8 The amount of any "topping up" transfers. (6.8.2)

3.6.9 The accounting policy adopted for setting up a provision for unexpired risks and its changes from one financial period to the next. (7.4.1)

3.6.10 The accounting policy adopted for discounting claims together with full details of its operation. (8.3.4 and 8.4.2)

3.7 Long-term business accounting practice - premiums

3.7.1 All non-linked business premiums are to be recorded when due for payment. (4.3.1)

3.7.2 Old unpaid premiums are to be written off as soon as practicable. (4.3.1)

3.7.3 Estimates for pensions business renewal premiums are to be included. (4.3.2)

3.7.4 Linked business premiums are to be recorded when received or when the liability is set up. (4.4.1)

3.7.5 All premiums are to be shown gross. Reinsurance premiums are to be separately disclosed. (4.5.2)

3.8 Long-term business accounting practice - expenses

3.8.1 A clear distinction is to be made between capital and revenue expenses by means of an internal classification. (5.1.2)

3.8.2 Expenses are to be recorded on an incurred basis. (5.1.6)

3.8.3 The acquisition expenses accounting policy is to be compatible with the policy adopted by the actuary when valuing the long-term liabilities. (5.4.1, 5.4.2)

3.8.4 Expenses attributable to the investment activities should be charged against investment income. (5.5)

3.8.5 Corporate activity expenses should be charged either to the revenue account or to the profit and loss account as considered to be appropriate by the enterprise. (5.6)

3.8.6 The individual enterprise should decide in accordance with generally accepted accounting practice what constitutes expenditure of a capital nature and how the expenditure will be treated for amortisation purposes. (5.7)

3.9 <u>Long-term business accounting practice - claims</u>

3.9.1 Full provision is to be made for all non-linked claims when notification is received. (6.5)

3.9.2 Linked business claims are to be recognised when the policy ceases to participate in the fund. (6.6)

3.9.3 All claims are to be shown gross. Reinsurance claims are to be separately disclosed. (6.7.1)

3.10 <u>Long-term business disclosure</u>

The following should be disclosed:-

3.10.1 The accounting policy adopted for premium recognition. (4.6.1)

3.10.2 An analysis of net premium income. (4.6.3)

3.10.3 New premium income figures. (4.6.4)

3.10.4 The policy adopted for capitalising expenditure. (5.8)

3.10.5 The accounting policy adopted for claims recognition. (6.8.1)

PART 4 Premium Income

4.1 General business annual and deferred annual accounting bases

4.1.1 As the majority of general insurance business is for a short (one year) time period, following the accruals concept premiums should be recorded in the period in which they incept (premiums written). Estimates, where appropriate, should be made in order to comply with this basic principle. Pipeline premiums, i.e. premiums in respect of risks underwritten and incepted prior to the accounting date but not entered into the accounting records until the following period, should be estimated for inclusion in the accounting records of the inception year.

Should an enterprise 'pre-debit' renewal premiums (i.e. debit the renewal before acceptance) then a lapse rate should be applied based on previous experience in order to calculate a provision for premiums which have been debited but are expected to be cancelled subsequently.

If premiums are to be received by instalments then the total premium should be recorded, the outstanding instalments being carried to current debtors.

Premiums should include any premium portfolios payable by the enterprise, after deduction of any premium portfolios refunded to or received by the enterprise.

For some classes of business (e.g. certain marine business) premiums are notified and recorded net of brokerage and commission in which case the premiums should be grossed up to reflect the deductions (even though this may have to be on an estimated basis).

4.1.2 If premiums are subject to reduction (for example employers liability),an adjustment for such reduction which should be related back to the inception date should be made as soon as it can be foreseen (prudence concept). However where premiums are subject to increase retrospectively (for example, based on claims experience or declaration of sums insured), recognition of potential increases should be deferred unless those adjustments (additional premiums) can be ascertained with reasonable certainty.

4.1.3 Due to the fact that not all the risks incept at the commencement of the enterprise's accounting period, in accordance with the matching concept a portion of the premium representing the period of risk relating to subsequent accounting periods should be transferred to such subsequent accounting periods (unearned premiums), in order to be matched against possible claims occurring in that accounting period. (See also unexpired risks Part 7)

Usually the portion of the premium to be carried over to a subsequent accounting period (unearned premiums) is calculated in proportion to the unexpired period of risk of the polic or contract. When the risk is expected to be incurred unevenly wit the contract period (e.g. risks of a seasonal nature such as hail. frost etc.) a basis other than time apportionment may be appropr

In the case of additional and return premiums when calculating the portion to be carried over to a subsequent accounting period regard should be had to the inception date of the policy or contract and the fact that the period of risk might have already expired.

4.1.4 If the risk underwritten extends for more than one year the total premium should be recorded and the portion not relating to the current accounting period should be included within the unearned premium provision.

4.1.5 Provisions for unearned premiums are frequently stated in financial statements net of deferred acquisition expenses. Premiums earned, (that is premiums written adjusted by the unearned premium provision at the beginning and end of the period) therefore also reflect opening and closing deferred acquisition expenses (but not the acquisition expenses incurred in the period). In order to present an undistorted figure for the unearned premium provision deferred acquisition expenses should be dealt with as a separate item (see paragraph 5.2.3).

4.1.6 When using the deferred annual accounting basis it is not necessary to create a specific provision for unearned premiums at the end of the open year or to estimate pipeline premiums. However the balance on the open year should be tested for adequacy having regard to estimates of unrecorded premiums and claims; if insufficient then it will have to be "topped up". (See paragraph 6.3)

4.2 General business - fund accounting basis

4.2.1 All premiums notified in an accounting period should be recorded in that period and attributed to the appropriate underwriting year account. The basic accounting principles which apply to the annual and deferred annual accounting basis apply to each underwriting year.

In the same manner as for deferred annual accounting, no specific provisions are created for unearned premiums at the end of the open years and no estimates are made for pipeline premiums but the fund should be tested for adequacy. Should a "top up" be required, this can come from the profit and loss account or from a disclosed reserve. (See paragraphs 6.4.3, 6.4.4, 6.4.5.)

It is essential that the balance carried forward, made up of various underwriting years open and closed, is at all times sufficient to meet the estimated future liabilities.

4.3 Long-term business - non-profit and with profit (fund accounting basis)

4.3.1 Premiums, which include single premiums and considerations for the granting of immediate and deferred annuities, should be recorded when due for payment.

If premiums remain unpaid for a time and are unlikely to be collected this will have the effect of increasing artificially the balance sheet items, unpaid premiums and the long-term insurance funds. Following the prudence concept action should be taken to eliminate these unpaid premiums once identified as such. In order to achieve this the enterprise should, if policy conditions allow, create a loan to pay off the unpaid premiums. The loan increases each financial period by the amount of the annual premium until such time as the liability (surrender value) on the policy, assuming all the premiums are paid, equals the loan. The policy is then surrendered which pays off the loan. If policy conditions do not allow (i.e. non-forfeiture) then the objective stated above can be achieved either by charging interest on the unpaid premiums or converting the policy to a paid up status as soon as practicable.

4.3.2 In pension business when it is impracticable to determine the actual renewal premium due to time delays a reasonable estimate should be included.

4.4 Long-term business - investment linked (fund accounting basis)

4.4.1 Due to the fact that policyholders receive benefits which reflect the market/assessed value of the assets underlying the contract, premiums should be recorded as and when received or alternatively when the liability is set up. Premiums should be accounted for in the same accounting period and consistently with the calculation of the relevant policy liability.

4.5 Reinsurance

4.5.1 Reinsurance premiums payable or receivable, either actual or estimated, follow the basic principles as outlined in paragraph 4.1.1 for general business accounted for on an annual or deferred accounting basis; paragraph 4.2.1 for general insurance business accounted for on a fund basis, and paragraph 4.3 and 4.4 for long-term business. All outwards reinsurance premiums are to be recorded in the same accounting period as the premiums for the corresponding direct or inwards reinsurance being reinsured.

4.5.2 In order that the overall size of an enterprise's operation may be appreciated the total amount of premiums should be shown including both direct business and inwards reinsurance business, on a gross basis. The reinsurance cessions should be shown as a deduction thus displaying a business retained situation. This should apply to both general business and long-term business premiums.

4.6 Additional Disclosure

4.6.1 The accounting policies adopted for premium recognition and for the provision for unearned premiums should be disclosed in the financial statements. Disclosure should give a broad understanding of the method of calculation adopted for the principal classes of business transacted by the enterprise. Any change in method must be disclosed together with a quantification of its effect.

4.6.2. Where for certain classes a fund accounting basis is adopted this policy should be disclosed together with the classes involved and with the extent of the time deferral to profit recognition.

4.6.3 An analysis of premiums written net of reinsurance into principal classes and an analysis of the aggregate net premiums written into geographical areas should be disclosed.

For both general business and long-term business the enterprise should determine its own principal classes.

Marine, aviation and transport business accepted in the United Kingdom and reinsurance business accepted in the United Kingdom, may be regarded as United Kingdom business for this purpose.

As regards home/foreign business, it would be acceptable for this to be included within the general classification of "Other Overseas" business if home/foreign premiums in aggregate are not more than 5% of the total premium income. In the event that home/foreign business exceeds this percentage, the enterprise would be expected to analyse the premium income relating to the more material risks taken on under this heading territory by territory leaving the remaining premium income to be aggregated under the heading of "Other Overseas".

When long-term business is transacted there should be disclosed an analysis into the principal classes of the new annual premiums and the new single premiums.

PART 5 Expenses

5.1 General

5.1.1 The accounting treatment of expenses incurred in carrying on the business of insurance depends on three factors:

1. The nature of the expenses.
2. The activity to which the expenses are attributable.
3. Whether the expenses should be charged against income or capitalised either as part of the cost of acquisition of an asset or as a deduction from the proceeds of disposal of an asset.

5.1.2 Whilst current accounting practice varies, it is recommended in this statement that a clear, consistent policy should be established and followed based on a distinction between expenses of a revenue nature and those of a capital nature. To achieve this distinction all expenses incurred should be classified internally according to both their nature and the activity to which they relate.

5.1.3 Whilst the nature of the expenses incurred by insurance enterprises can be classified under certain common broad headings it is a matter for each enterprise to decide on how these expenses should be classified for internal management purposes.

It is not intended in this statement to lay down any recommended classification of expenses for this purpose but it is felt important, to ensure a degree of consistency in treatment between enterprises that some general guideline is given. A suggested classification is given in the appendix.

5.1.4 For the purpose of determining the appropriate accounting treatment, however, the nature of the activity to which the expenses are attributable should be identified. Such activities can be conveniently grouped under the following headings:

1. Underwriting: the acquisition and maintenance of insurance business.
2. Claims, including annuity and other payments to policyholders.
3. Investment.
4. Corporate.
5. Expenditure of a capital nature.

5.1.5 The first four headings embrace all expenses of a revenue nature (including the amortisation of capital expenditure) where the accounting treatment is based on the accruals and matching concepts, i.e. all such expenses should be recorded on an incurred basis and charged against income on the basis that such expenses should be matched, so far as practicable, with the corresponding income in the appropriate accounting period.

Expenditure of a capital nature should be recorded in accordance with the accruals concept and dealt with in the accounting period in which the expenditure is incurred. Capital expenditure may be either written off in the accounting period in which the expenditure was incurred or be amortised and charged against income over the periods benefiting from the expenditure.

5.1.6 The basic principle is that all expenses incurred in a particular accounting period should be recorded in that period with full provision being made for any expenses incurred but not paid in that period in accordance with the accruals concept.

5.1.7 The accounting treatment of such expenses is then determined by the basis of accounting adopted as referred to in paragraph 1.5.

5.2 General business -annual and deferred annual accounting bases

5.2.1 Under the annual or deferred annual accounting basis, expenses should be charged against income of the appropriate accounting period in accordance with the matching concept. This requires expenses attributable to underwriting activities to be charged against income over the same period as the premiums are credited as earned and necessitates a proportion of such expenses being carried forward from one accounting period to the next. The expenses carried forward are referred to as deferred acquisition expenses.

5.2.2 An accurate method should be adopted for the calculation of the quantum of deferred acquisition expenses to be carried forward. Accordingly the calculation should be based on the actual expenses incurred in relation to the premiums written for each class of insurance business transacted. It may not be possible to adopt this method of calculation for proportional reinsurance business because the ceding enterprise when advising the reinsurer of the premium provision includes in that provision an amount for deferred acquisition expenses. In that case a straight percentage of the premiums should be used to calculate the quantum of the carry-forward.

5.2.3 To avoid masking the actual amount of the unearned premium provision and possibly giving a misleading picture, the amount of the deferred acquisition expenses carried forward should be disclosed separately and not deducted from the unearned premium provision. This approach has the merit of not distorting ratios based on earned premiums because income and expenses are properly segregated. Consequently any acquisition expenses carried forward should be disclosed separately in the balance sheet.

5.2.4 The net change in deferred acquisition expenses should be treated as a disclosed adjustment to the expense item in the revenue account thus showing the actual expense amount incurred in the revenue account.

5.2.5 Expenses attributable to the claims activitity should be charged in full against income of the accounting period in which they are incurred. There is no allocation to a subsequent accounting period for a proportion of such expenses as for deferred acquisition expenses on the grounds that expenses attributable to claims are regarded as wholly incurred in the accounting period in which the incident giving rise to the claim occurred and are thus included in paid claims and outstanding claims figures. (see paragraph 6.1.4.)

5.3 General business - fund accounting basis

5.3.1 Expenses should be recorded and charged in the accounting period in which they are paid. It is not necessary to make specific provisions for any expenses incurred but not paid at the end of each accounting period and there is no need to allocate to a subsequent accounting period a proportion of expenses charged in an earlier accounting period as it is assumed that by the time the underwriting result is determined, the period of risk will have expired and all expenses attributable to that year will have been incurred and recorded.

5.4 Long-term business - fund accounting basis
Non-profit and with profit

5.4.1 Acquisition expenses incurred on writing new business may exceed the first annual premium and if so it will be necessary to finance these expenses in the expectation that they will be recouped from subsequent premiums. This situation is taken into account by the appointed Actuary when he values the policy liabilities.

In some instances the Actuary adopts different principles resulting in acquisition expenses being regarded as a disclosed balance sheet item and amortised according to a predetermined set formula.

The accounting for acquisition expenses and whether or not they should be deferred should be compatible with the policy adopted by the Actuary when valuing the long-term policy liabilities.

Investment linked

5.4.2 Due to the fact that policyholders receive benefits based on assets acquired the acquisition of which is dependent upon the contractual net resources available, there should be no deferral of acquisition expenses and the accounting therefor should be compatible with the policy adopted by the Actuary when valuing the relevant liabilities.

5.5 Investment

Expenses attributable to the investment activities, i.e. those relating to the buying, handling, holding and selling of all types of investments together with staff and office costs etc. should be charged against the investment income wherever shown. Stamp duty, brokerage etc., which are regarded as part of the capital cost of the investment, are excluded from the charge against investment income.

5.6 Corporate expenses

Corporate activity expenses should be charged either to the revenue account or to the profit and loss account as considered to be appropriate by the enterprise.

5.7 Capital expenses

It should be left to the individual enterprise to decide in accordance with generally accepted accounting practice what constitutes expenditure of a capital nature and how the expenditure will be treated for amortisation purposes.

5.8 Additional disclosure

The policy adopted for capitalising expenditure should be disclosed and the items to which the policy refers stated. If the enterprise does not classify any expenditure as of a capital nature then this fact should be disclosed.

PART 6 Claims Arising From Insurance Contracts As Regards Insurers

6.1.1 Claims Incurred

In accordance with the accruals or matching concept when accounting for incurred claims on general insurance business it is essential to ensure that an insurance enterprise charges against the revenue of an accounting period the total estimated ultimate cost of settling all claims arising from events which have occurred up to the end of that period whether or not reported by that date. The charge will accordingly include all amounts paid including claims handling expenses (see paragraph 6.1.4) during the period whether relating to claims arising from events occurring during that period or previous periods. Full provision should be made at the end of the period for the estimated ultimate cost of all claims not settled at that date, whether arising from events occurring during that period or earlier periods and whether or not notified before the date on which the records are closed.

The charge for the accounting period will accordingly reflect any differences between payments made during the period relating to events occurring in previous periods and the provision made at the end of the previous period. It will also reflect any differences between the provision made at the end of the period for claims still unsettled arising from events occurring in previous periods and the corresponding provision at the end of the previous period.

Adjustments for claims portfolios assumed or transferred should be included with claims incurred.

For long-term insurance business, the same basic principle applies although the accounting treatment is based on a distinction between the provision necessary at the end of an accounting period for unsettled claims which have been notified and those which have not. A specific provision is made for the former whilst the latter are included in the actuarial valuation of liabilites.

6.1.2 Claims Outstanding - Reported

The amount provided for settling all reported claims arising from events which have occurred before the end of the accounting period should be based on the estimated ultimate cost at which the claims are expected to be settled less amounts already paid in respect of these claims. This should take into account the levels of inflation and other factors such as increases in court awards affecting different categories of claim. In long-term business as the amount of the claim is predetermined it will not be necessary to take account of inflation.

This provision is necessarily the result of a series of estimates and judgements which should be based on individual case estimates, statistical calculations and management judgement, as considered appropriate. The provision should be created as accurately as possible, having regard to prudent assumptions about the level at which claims are expected to be settled. The provision for claims outstanding will include an amount for the additional costs expected to arise on claims settled prior to the end of the accounting period but which it is anticipated will be reopened.

An enterprise may consider it appropriate to discount some of its general business claims outstanding. See Part 8.

6.1.3 Claims Outstanding - Incurred But Not Reported (IBNR)

An amount should be provided for the estimated ultimate cost of claims incurred but not reported to the enterprise by the end of its accounting period. The provision should be created as accurately as possible based on a number of factors, such as historical experience, changes in the nature and amount of business written, trends in claims frequency and variations in average incurred cost per claim, inflation and the latest available information at the time of the preparation of the financial statements.

The provision should be included within the claims outstanding provision.

6.1.4 Claims handling expenses

Any expenses associated directly or indirectly with paid claims should be included in claims incurred.

Claims handling expenses comprise two elements, direct and indirect. Direct expenses are those which are readily identified to a particular claim (such as legal, medical, surveying and engineering fees). Indirect expenses are all the other expenses of running a claims operation which are not readily identifiable to specific claims.

Both direct and indirect expenses relate to policies previously written. Therefore following the accruals concept these expenses should be provided for in the accounting period in which provision is made for the associated claims. For direct expenses full provision should be made. For indirect expenses, as it is not always possible to achieve a precise matching with the relevant claims an estimated amount should be included in the provision recognising that some indirect expenses have already been incurred and therefore will not have to be included in the provision.

This provision should be included within the claims outstanding provision.

6.1.5 Recoverable amounts

In setting up claims provisions and recording claims payments any amounts receivable or received as a direct result of obtaining the legal ownership of insured property or acquiring the rights of the policyholder against third parties following the settlement of a claim should be taken into account, (salvage and subrogation).

Where reinsurance contracts have been entered into, recoveries for claims should be recorded including estimates where appropriate. The security of the reinsurer should be considered when assessing the recovery.

6.2 General business - annual accounting basis

At the end of the accounting period full provision should be made for all claims outstanding, whether notified or not, together with attributable claims handling expenses.

6.3 General business - deferred annual accounting basis

At the end of the open year the net balance arising will be tested for adequacy against the estimated future unrecorded income and outgo, including attributable claims handling expenses. If the net balance is found to be insufficient it will have to be "topped up" by a transfer from profit and loss account or from a disclosed reserve. As the resultant net balance will cover the future estimated settlements there will be no necessity to set up any additional claims provisions.

At the end of the closed year full provision must be made for all claims outstanding and attributable claims handling expenses.

6.4 General business - fund accounting basis

6.4.1 Although the fund accounting basis results in the deferring of the recognition of any profit attributable to the business until the account is "closed", the prudence concept requires that any anticipated eventual loss should be recognised in the financial statements as soon as it can be foreseen. As with the deferred annual accounting basis, the net balance at the end of the open year will be tested for adequacy against the estimated future unrecorded income and outgo including attributable claims handling expenses.

6.4.2 It is essential that the balance carried forward in the fund is at all times sufficient to meet the anticipated future liabilities and if, therefore, the fund carried forward at the end of an accounting period is deemed to be insufficient to meet the anticipated liabilities arising from such business, it will be necessary to "top up" the fund.

6.4.3 The amount required to "top up" a fund would normally be transferred from the profit and loss account. It is, however, acceptable for such transfers to be made from a reserve provided that the source and the amount are disclosed.

6.4.4. The essence of accounting on a fund basis is that because of inherent uncertainty, credit should not be taken to profit and loss for an estimated surplus until the account is closed, (the prudence concept). It therefore follows that cross-funding as described in paragraph 6.4.5 undermines the whole purpose of fund accounting and as an accounting practice is unacceptable.

6.4.5. The practice of cross-funding involves the setting off of an estimated surplus against an estimated deficiency between classes of business separately accounted for on a fund basis.

Cross-funding can arise in the following circumstances :

(i) Where the balance of a fund at the end of an underwriting year for one class of business is deemed to be more than sufficient to meet the anticipated liabilities for that class of business and the estimated surplus is regarded as available for offset against an estimated deficiency at the end of the same underwriting year on a different class of business. This can be described as cross-funding within the same underwriting year.

(ii) Where the balance of a fund at the end of an underwriting year for one class of business is deemed to be more than sufficient to meet the anticipated liabilities for that class of business and the estimated surplus is regarded as available for offset against an estimated deficiency on either the same class of business or a different class of business at the end of a different underwriting period. This can be described as cross-funding between different underwriting years.

6.4.6 It is acceptable to make transfers between different classes of business within the same underwriting year provided that the different classes of business are managed together and accounted for in the financial statements as one fund. This is not regarded as cross-funding.

6.4.7 Where a fund has been "topped up" in an accounting period for an underwriting year and at the end of a subsequent accounting period it is evident that the amount transferred to augment the fund for that underwriting year was excessive, a transfer may be made out of the fund for that underwriting year of an amount up to but not exceeding the amount transferred into the fund up to the end of the previous accounting period. Such a transfer may be made either to the profit and loss account or to the reserve depending upon which source provided the transfer.

6.5 Long-term business non-profit and with profit-fund accounting basis

The accounting liability for claims outstanding relating to non-profit and with profit insurance contracts should be accrued when the insured event occurs or is notified. Where admission of the claim terminates the liability under the long-term policy the accrual should be recorded consistently with the removal of the particular policy from the actuarial valuation of policy liabilities.

Where a claim is payable and the policy remains in force as arises under a continuous disability policy or in the settlement of an annuity contract the amounts due for payment should be treated as claims payable. The remaining liabilities should be included in the actuarial liability.

The liability taken up for claims outstanding should be based on the estimated ultimate cost of settling the claims including where appropriate claims handling expenses.

Usually it will not be necessary to set up a separate IBNR claims provision as until recorded as a claim the liability will be included in the actuarial valuation of liabilities.

6.6 Long-term business investment linked fund accounting basis

The recognition of claims paid under investment linked business should be accounted for at the time when the policy ceases to participate in the fund.

6.7 Reinsurance

6.7.1 If reinsurance recoveries are offset without disclosure against the claims to which they relate an incomplete picture will emerge, as the totality of the claims, for which the enterprise is liable, will not be displayed. Therefore all claims in the revenue account should be shown on a gross basis. The reinsurance recoveries should be shown as a deduction giving the business retained position. This is consistent with the recommended accounting practice for premiums and applies to both general business and long-term business.

6.8. Additional Disclosure

6.8.1 The accounting policies adopted for claims recognition should be disclosed and should include a clear indication of the policies adopted with regard to:

- IBNR
- Claims handling expenses
- Salvage and other recoveries
- Allowance for increases in claims costs, e.g. future inflation.

6.8.2 The amount of any "topping up" transfers to open years - this applies to general business accounted for on a deferred annual or fund basis.

PART 7 Unexpired Risks

7.1 If it is anticipated that the enterprise will incur operational losses during the unexpired period of risks on its existing insurance contracts, then, following the prudence concept, it will be necessary to create an unexpired risks provision additional to the claims provision and the unearned premium provision.

The question of whether or not to set up an unexpired risks provision should be viewed from the enterprise's general financial position and not purely from that of the insurance class. If an enterprise has subsidiary enterprises then these should be viewed as independent enterprises and treated accordingly.

When considering the necessity for an unexpired risks provision it would be in accordance with the accruals concept to recognise that premium income is not the only source of revenue generated by underwriting. Therefore it is permissible to take account of the investment income on assets representing all the technical funds in the calculation of the unexpired risks provision. Where an enterprise discounts some of its claims outstanding then the investment income of the assets hypothecated to the discounted claims should be excluded from the calculation of the unexpired risks provision.

7.2 Deferred acquisition expenses should also be considered when setting up a provision for unexpired risks. Basically, there are two methods of presenting the amount of the provision for unexpired risks

- the shortfall in the unearned premium provision is first recognised by writing off deferred acquisition expenses to revenue account and, if the shortfall is greater than the unamortised acquisition expenses, a provision is made for the excess; or

- a provision is made for the whole of the shortfall including any unamortised deferred acquisition expenses (and deferred acquisition expenses are carried forward separately).

The first alternative is based on the theory that, where the recovery of deferred expenses is in doubt, this should be recognised in the financial statements by writing off these expenses before any additional liabilities are recorded. The second alternative is based on the theory that, just as the provision for unearned premiums and deferred acquisition expenses are separate (but related), deferred acquisition expenses and the possibility of an overall loss arising are separate (but related); accordingly, they should be accounted for separately in the financial statements as the additional liabilities are not directly related to the expenses deferred but arise from independent circumstances. The second alternative has the merit that income and expenditure are properly segregated and, unlike the first alternative, it does not result in distortion of the ratio of claims and expenses to earned premiums.

7.3 Therefore when an unexpired risks provision is set up provision should be made for the whole of the unearned premium provision shortfall including any unamortised deferred acquisition expenses. Deferred acquisition expenses are to be carried forward separately.

7.4 <u>Additional Disclosure</u>

7.4.1 The accounting policy adopted for the provision for unexpired risks should be disclosed as also should the amount and its changes from one accounting period to the next.

PART 8 - Discounting

8.1 Current Practice

For the great majority of insurance enterprises current accounting practice for general insurance business claims outstanding and attributable claims handling expenses is that they are provided for in full at estimated ultimate settlement cost. Accordingly the provision allows for increases in claims costs between the date at which the financial statements are drawn up and the date of actual settlement but does not anticipate the future return from any investments held. As a result this future investment return provides a margin which is available should the claims development prove to be more adverse than expected. A minority of insurance enterprises employ discounting techniques for some classes such as workers' compensation.

8.1.2 There is a distinction to be drawn between general insurance business claims and long-term insurance business claims. In the case of general insurance business, policies will normally specify the type of risks insured against and the maximum amount of cover provided. The amount of a claim under such a policy will not be certain but will depend upon the circumstances giving rise to the claim. There can be considerable uncertainty therefore as to the actual liability in respect of a claim until all the relevant information has been collated. In the interim period it will be necessary to estimate the amount of the liability based upon available information including the anticipated settlement date.

8.1.3 By contrast, long-term business insurance policies are more certain in their terms both as regards the risks that are insured against and the amount of cover provided which is often quoted in absolute terms. In many instances the claims settlement date will also be known. Under these circumstances the ultimate amount of the liability under a policy can be determined with a reasonable degree of accuracy. It is possible, and appropriate, for the liability to be determined during the course of the policy by discounting the ultimate liability to a present day value by making due allowance for subsequent income flows. Due to the fact that for long-term business claims will often be distant future events and future income flows will be significant, it is not possible for the Appointed Actuary to estimate properly for long-term business liabilities without discounting. The Appointed Actuary undertakes this function in his valuation of the long-term business liabilities and in his assessment of the adequacy of the long-term business fund to meet those liabilities

8.2 The Issues

8.2.1 The arguments which are employed against discounting of general business claims provisions emanate mainly from SSAP 2 which sets out the basic concepts of accounting, one of which is prudence. Prudence dictates that the liability to be provided for should be the full amount expected to be paid in the future and that any diminution of this amount would be tantamount to an anticipation of profit, which is contrary to the concept. It is also true that in many cases estimates of the time when payments will be made, as well as the amounts which will be payable, are so uncertain and speculative that discounting of claims cannot produce a more accurate figure than providing for the expected full amount at the outset. The principal arguments for discounting are that it would be inconsistent to recognise as an expense the anticipated effect of inflation and settlement trends on claims but not to recognise also the offsetting effect of the time value of money and that by not discounting, secret or hidden margins could be created to the detriment of current shareholders. There is a view that discounting is not an anticipation of profit in the terms of SSAP 2 because there is a fundamental difference between the premature inclusion of a source of profit or income in the profit and loss account and the techniques used in establishing the quantum of a liability.

8.2.2 In practice, the time taken to determine and settle a claim can vary from weeks in, for example, a case of material damage to twenty years or more in, for example, the case of industrial disease. Furthermore, some claims such as those for workers' compensation give rise to liabilities payable at regular intervals over many years. Where claims are notified, agreed and settled in a comparatively short time period (for example motor claims not involving personal injury) discounting is unlikely to produce any significant financial effect. However, where the notification of claims, their agreement and settlement is spread over a considerable period of time, the payment patterns and ultimate expenses are fixed or reasonably determinable and there is a soundly based evaluation of the amount and timing of the claim, a case can be put for discounting these liabilities to reflect anticipated future investment income, by recording claims provisions and provisions for claims handling expenses at the present value of anticipated cash payments.

8.3 Recommendations

8.3.1 There should be no bar on explicit discounting of general business claims, if the amount of the liability and the payment date can be determined with reasonable certainty, (the choice of whether or not to discount to be left to the enterprise). Implicit discounting, i.e. an accounting practice which places a present day value on a provision for an outstanding claim without disclosure of that fact, is not acceptable as it conflicts with basic accounting principles.

8.3.2 The rate used for discounting liabilities should not exceed a conservative estimate of the long term rate of investment income which the enterprise considers is most likely to be earned on its investment portfolio. The rate is unlikely to exceed the rate then being earned on its existing portfolio.

8.3.3 A portion of the before tax investment income compatible with the discount factor should be credited to the revenue account (rather than to profit and loss account), and separately disclosed. It is argued that a before tax portion should be used rather than an after tax portion as all the other items in the revenue account are on a before tax basis, and this accords with the consistency concept. If there is no credit of investment income the increase in claims and direct claims handling expenses in succeeding accounting periods will impose a strain on revenue arising from the increase in claims liabilities as they approach the anticipated settlement dates.

8.3.4 The accounting policy adopted for any discounting of claims outstanding and direct claims handling expenses should be disclosed in the financial statements. In particular, disclosure should be made of:

- the classes or groupings of business involved;
- the methods applied, including
- the range of discount rates used;
- the period of years over which the significant majority of claims are expected to be settled;
- the treatment of the attributable investment income.

8.4 Consequences of Discounting

8.4.1 If enough statistical data is available it may be possible to utilise discounting techniques, where a deferred annual or fund accounting basis is used, for the purposes of determining whether or not the balance carried forward is adequate to cover all future obligations. However, whilst discounting may be utilised so as to demonstrate that there is no need to 'top up' from profit and loss account or from a disclosed reserve, discounting must not be used as a basis for transferring surpluses to profit and loss before the expiry of the period adopted for profit recognition. This is in accordance with the prudence concept whereby no anticipation of profit is permitted.

8.4.2 Where technical provisions are discounted, it follows that reinsurance ceded should also be discounted so that the overall effect of discounting on the results reflects the 'net account'. Disclosure should be made in accordance with paragraph 8.3.4 and can be combined with the claims information.

PART 9 - Legal Requirements In Great Britain

Section 257 of the Companies Act 1985 permits insurance companies to prepare accounts in compliance with Chapter II of Part VII of and Schedule 9 to the Companies Act 1985 instead of Chapter I of Part VII and Schedule 4 of that Act.

Paragraph 28(1) of Schedule 9 grants certain disclosure exemptions to insurance companies. Paragraph 28(2) of Schedule 9 provides that the accounts of a company shall not be deemed, by reason only of the fact that they do not comply with any requirement of Part I of that Schedule from which the company is exempt by virtue of Paragraph 28, not to give the true and fair view required by the Companies Act 1985.

APPENDIX

Suggested Classification of Expenses

1. Underwriting expenses: the acquisition and maintenance of insurance business.

   Expenses that vary with and primarily relate to the acquisition of new insurance contracts and the maintenance and renewal of existing insurance contracts including reinsurance contracts. For example :

   Commission.
   Advertising.
   Salary costs and related expenses of sales, sales administration, underwriting staff and renewal departments including supervision and recruitment.
   Office costs - heat, light, telephone, stationery, space etc. of above.
   Computer usage charges.
   Inspection fees.
   Medical fees
   Premium Taxes less recoveries.

2. Claims, including annuity and other payments to policyholders.

   Direct and indirect expenses relating to the negotiation and settlement of claims for example :

   Legal and survey fees connected with claims.
   Salary costs and related expenses of claims handling staff including supervision and recruitment.
   Office costs - heat, light, telephone, stationery, space etc. of above.
   Computer usage charges.

3. Investment

   All expenses relating to the buying, handling, holding and selling of all types of investments, including staff involved, their office space, computer usage etc., excluding stamp duty, brokerage etc., which are regarded as part of the capital cost of the investments.

4. Corporate activity.

Expenses which do not fall into 1, 2, or 3 above, for example:

Audit fees.
Directors' fees and expenses.
General management and support staff, salary costs and related expenses.
Office costs - heat, light, telephone, stationery, space etc. of above.
Computer costs if appropriate.
Central financing charges.
Shareholders'/proprietors'/members' meetings.

5. Capital.

Expenses deemed to be of a capital nature for example :

Computers and peripheral equipment.
Motor vehicles.
Printing machinery.
Canteen equipment.
Telephone exchanges.
Major items of office machinery.

Association of British Insurers
23rd December 1985
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