RECOGNITION AND MEASUREMENT OF SHORT-TERM INSURANCE CONTRACTS

Contents

	Paragraphs
Introduction	.01 – .06
Annual basis of accounting	.07 – .10
Premiums	
Gross written premiums	.11 – .14
Pipeline premium	.15 – .17
Lapses and adjustments	.18 – .20
Earned premium	.21 – .23
Reinsurance premium	.24 – .25
Claims	
Gross claims	.26 – .33
Claims recoveries	.34 – .35
Claims handling expenses	.36 – .37
Liability adequacy test	.38 – .39
Unexpired risks provision	.40 – .47
Commission	.48 – .50

Introduction

The objective of this circular is to provide a point of reference for the recognition and measurement of insurance contracts for registered short-term insurers. The circular replaces the *Accounting Guide on Short Term Insurance* issued in February 2001. .01

The circular should be read within the context of IFRS 4(AC 141) – *Insurance Contracts*. IFRS 4(AC 141) does not provide comprehensive guidance on the recognition and measurement of insurance contracts. IFRS 4(AC 141) allows an insurer in many cases to continue with existing accounting policies and provides guidance on changes in accounting policies. This circular outlines the recognition and measurement practices that applied to existing South African short-term insurers in accounting for insurance contracts. Although there was no previous accounting standard for short-term insurers, the previous *Accounting Guide on Short Term Insurance* issued in February 2001 .02

represented existing GAAP for Short-term insurers at the date of transition to IFRS. In addition, IFRS 4(AC 141) may still require some changes to existing practices. For example, the application of IFRS 4 (AC 141) may affect the accounting of cells facilities involving insurers, which is not dealt with in this circular.

.03 The references to insurance contracts relate to insurance contracts as defined in IFRS 4(AC 141). The circular does not provide guidance on recognition and measurement for insurance contracts that are excluded from the scope of IFRS 4(AC 141).

.04 IFRS 4(AC 141) applies to all entities that have insurance contracts and therefore applies to entities that might not be registered insurance entities in terms of the Short-term Insurance Act, 1998. Therefore it may not be appropriate for entities that have insurance contracts, but who are not registered short-term insurers, to use the guidance contained in this circular as they would continue to apply existing GAAP when they adopted IFRS 4. (SAICA has issued a separate guide that addresses accounting for insurance contracts issued by medical schemes.)

.05 Short-term insurers are subject to regulation by the Registrar of Short-term Insurance in terms of the Short-term Insurance Act. This circular is not directed at returns that the Registrar requires from short-term insurers in a prescribed format.

.06 References to short-term insurers throughout this circular include reinsurers, unless specifically stated to the contrary.

Annual basis of accounting

.07 Underwriting results are determined on the annual basis of accounting, irrespective of the nature of the insurance business. The fund basis should not to be used.

.08 Short-term insurance activities are accounted for on the annual accounting basis. Under this basis of accounting, the underwriting result disclosed in the financial statements is determined at the end of the accounting period that reflects the profit or loss from providing insurance cover during that period. This would include anticipated losses arising in subsequent periods in respect of commitments entered into prior to the end of the accounting period and any adjustments to claims provisions raised during earlier accounting periods.

Under the fund basis of accounting, premiums, claims and associated expenses are related to the underwriting year in which the policies incept. The recognition of any underwriting profits is deferred to a subsequent accounting period but provision is made for losses as soon as they are foreseen. .09

The annual basis is considered to be a better indicator of current profitability than the fund basis, since profits and losses relate to more recent underwriting experience. The annual basis will normally require some estimation to be made at the balance sheet date, particularly with regard to outstanding claims and incurred but not reported claims. .10

Premiums

Gross written premiums

Gross written premiums in an accounting period comprise all premiums relating to policies incepting in the accounting period. They include the premiums for the whole period of risk covered by the policies regardless of whether or not these are wholly due for payment in the accounting period. Gross written premiums also include adjustments to the premiums received in respect of business written in prior accounting periods. .11

Gross written premiums comprise the gross amount payable by the policyholder to the insurer in terms of the insurance contract. .12

A common arrangement in short-term insurance is for premiums to be remitted to the insurer by intermediaries/brokers net of commission. This cash flow encompasses two transactions: the payment of gross written premium accruing to the insurer in terms of the insurance contract and the payment of commission accruing to the intermediary/broker in terms of the contract. These transactions need to be recorded separately, as premiums and commissions are disclosed separately in the financial statements. .13

Where premiums are received by instalments during the period of risk covered by the policies or contracts, any outstanding amount at the balance sheet date is treated as a receivable. .14

Pipeline premium

.15 The concept of gross written premium includes an estimate of pipeline premium.

.16 Consistent with the principles stated in paragraph .11 gross written premium is recognised from the date the policy incepts. Where there is insufficient information available at the end of the accounting period to enable a short-term insurer to identify the business written close to the reporting date accurately, an estimate is raised for that premium. That estimate is referred to as ‘pipeline premium’.

.17 Estimates of the amount of pipeline premium can be made based on information from prior periods adjusted for the impact of recent trends and events. In addition, information about pipeline premium may become available between the balance sheet date and the date of the completion of the financial statements, which may enable more reliable estimates to be made.

Lapses and adjustments

.18 Where an insurance company accounts for renewal premiums before contractual confirmation by the policyholder, a provision for anticipated lapses is established.

.19 If estimated written premiums are subject to subsequent adjustments, premium is adjusted when more information becomes available. The deposit premium is recognised and adjusted for any other relevant information, provided that it is expected that this amount will not be materially different from the actual amount of written premium.

.20 If written premiums are subject to a reduction, an adjustment for the reduction is made as soon as it becomes known.

Earned premium

.21 Premium revenue is recognised in the financial period in which it is earned. Therefore, premium written in a financial year would generally not equate to premium earned during the same period because the written premium would include amounts that are unearned at the reporting date. These amounts will be earned by the short-term insurer in subsequent accounting periods.

.22 Premium revenue is accounted for in the accounting period to which it relates. Premium revenue is recognised evenly over the period of the policy or in accordance with the pattern of the incidence of risk where the result is materially different. For example, for certain crop, contractors all-risks, and engineering all-risks insurance the risk is not constant during the term of the contract.

Earned premium relates to the risks covered during the accounting period. Some policies incepting in previous accounting periods will not have expired and the portion of the written premium relating to the unexpired period of these policies is carried forward as unearned premium and is treated as earned premium in the current accounting period or, where appropriate, future accounting periods. Premium written in the current accounting period is treated as earned premium except to the extent that it relates to unexpired periods of risk at the balance sheet date. .23

Reinsurance premium

Premium ceded under a reinsurance contract is recognised as an outward reinsurance premium expense in the financial period in which it is incurred. Inward reinsurance premium is recognised as revenue in the financial period in which it is earned. .24

Reinsurance premium ceded for the accounting period would normally not equate with reinsurance premium earned at the reporting date, since it is earned over the period of risk. For proportional reinsurance the period over which the reinsurance premium is earned is normally consistent with the pattern of risk of the underlying direct insurance policies. For non-proportional reinsurance the period over which the premium is earned takes into account the period of the reinsurance arrangement. .25

Claims

Gross claims

.26

Provision is made at the balance sheet date for the expected ultimate cost of settlement of all claims incurred in respect of events up to that date, whether reported or not, together with related claims handling expenses, less amounts already paid. If a liability exists but there is uncertainty as to its eventual amount, an estimate is made.

.27

The estimation of claims liabilities is an area of subjectivity, resulting from uncertainty as to the ultimate cost of settling claims in the future.

The uncertainty arises because the insurer has committed itself to meeting liabilities arising on claims, within the policy limits, which may expose it to a wide range of possible outcomes and which is often without limit as to time. The degree of uncertainty will vary widely, depending on the nature of the risk, the structure of the contract and, in some respects, market practice.

.28 In determining the claims liability, an insurer distinguishes between uncertainty as to whether or not a claims event has occurred and uncertainty over the eventual outcome of a claims event that has occurred and been reported. A liability is also recognised for claims events that have occurred but have not yet been reported. The liability is measured based on appropriate statistical and other techniques which address any uncertainty due to the fact that the resulting loss to the policyholder may not manifest itself until a considerable period after the end of the accounting period (perhaps several years) and in consequence may not be reported until then.

.29 Since written premium includes an estimate of pipeline premium, consideration is given to the impact of these premiums on the provision for outstanding claims.

.30 The level of claims provisions is set such that no adverse run-off experience is envisaged.

.31 In determining the sufficiency of evidence and the ability to measure claims costs, an insurer takes all reasonable steps to ensure that it has appropriate information with regard to its claims exposures. However, given the uncertainty in establishing a provision for outstanding claims, it is likely that the final outcome will prove to be different from the original liability established.

.32 In setting the provision, consideration is given to the probability and magnitude of future experience being more adverse than assumed. In some cases, there will be considerable uncertainty regarding future events. In these circumstances, a degree of caution will be necessary in the exercise of the judgement required for setting provisions such that liabilities are not understated.

.33 The IFRS 4(AC 141) Basis for Conclusions states that insurers sometimes measure insurance liabilities on a highly prudent basis that lacks the neutrality required by the IASB Framework. Because IFRS 4(AC 141), does not define how much prudence is appropriate, it cannot eliminate excessive prudence. However, IFRS 4(AC 141), paragraph 26 states: "*An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence.*"

Claims recoveries

Anticipated salvage or subrogation recoveries in respect of the accounting period are recognised in profit and loss. .34

Claims recoveries from reinsurers in respect of the accounting period are recognised in profit and loss. If these claim recoveries are accounted for as assets then it should considered whether they are impaired. .35

Claims handling expenses

Provisions are made at the end of the accounting period for all claims handling expenses to cover the anticipated future costs of negotiating and settling claims that have been incurred, whether reported or not, up to the balance sheet date. Separate provisions are assessed for each category of business. .36

.37

Claims handling expenses include the indirect costs of the claims handling department. In determining the provision for claims handling expenses, unless clear evidence is available to the contrary, it is assumed that the activity of the claims handling department will remain at its current level and therefore that the contribution to its costs from future new business will remain at the same level. Therefore, indirect costs in respect of the claims handling department are normally included in the provision for outstanding claims based on the percentage such costs represented of claims incurred (before taking account of claims handling costs) in the current accounting period.

Liability adequacy test

.38

Owing to the high degree of judgement involved in setting insurance liabilities, it is important for the insurer to assess whether those liabilities are sufficient to meet future obligations.

.39

IFRS 4(AC 141), paragraph 15 states: "*An insurer shall assess at each reporting date whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss.*"

Unexpired risks provision

.40 If the expected value of claims and expenses attributable to the unexpired periods of policies in force at the balance sheet date exceeds the unearned premiums provision in relation to those policies, after deduction of any deferred commission expenses, the insurer assesses the need for an unexpired risks provision.

.41 The need for an unexpired risks provision is assessed on the basis of information available at the balance sheet date. Claims events occurring after the balance sheet date in relation to the unexpired period of policies in force at that time are not taken into account in assessing the need for an unexpired risks provision.

.42 The insurer bases the assessment on the expected outcome of those contracts, including the available evidence of claims experience on similar contracts in the past year, as adjusted for known differences, events not expected to recur, and the normal level of seasonal claims.

.43 The above approach ensures consistency between short-term insurers regardless of the date of approval of their financial statements. It also ensures that claims that result from material events occurring early in an accounting period will be accounted for wholly in that period and not allocated between that and the immediately preceding accounting period, according to when the related policies incepted.

.44 In calculating the expected value of future claims in relation to the unexpired periods of risk on policies in force at the balance sheet date, the future investment return on investments supporting the unearned premiums provision and the unexpired risks provision may be taken into account. The unearned premium provision, net of deferred acquisition costs, is used for the purposes of calculating the unexpired risks provision.

The investment return taken into account is that which is expected to be earned by the investments held until the future claims are settled. .45

An assessment of whether or not an unexpired risks provision is necessary is made for each grouping or class of business that is managed, together with any unexpired risk surpluses and deficits within that grouping or class being offset. This is because groupings or classes of business that are managed together may be regarded as single reporting units, in relation to which it is appropriate to make an assessment in aggregate of whether or not an unexpired risks provision is required. For this purpose, business is only regarded as being 'managed together' where no constraints exist on the ability to use assets held in relation to such business to meet any of the associated liabilities, and either: .46

- there are significant common characteristics that are relevant to the assessment of risk and setting of premiums for the business lines in question; or
- the lines of business are written together as separate parts of the same insurance contracts.

.47

The unexpired risks provision only applies to policies with an unexpired risk period at the balance sheet date. Insurers should take note of the liability adequacy test discussed in paragraph .38 of this circular.

Commission

.48

Commissions paid to intermediaries are accounted for over the risk period of the policy to which they relate. The portion of commission which is deferred to subsequent accounting periods is termed a 'deferred acquisition cost'..

.49

Reinsurance commission is deferred in line with the reinsurance premium expense.

.50 Profit commissions receivable should be taken into account when they are likely to be realised, and are measurable.