Module G Unit 12

ACCOUNTING

Purpose

This unit is not intended to be a detailed technical review of accountancy, which would be an entirely separate exercise requiring more than one unit of coursework. Rather this is intended as an overview of the main aspects of the finances and accounting requirements of an insurance company.

Assumed knowledge

A basic understanding of the usual financial transactions made by an insurance company.

Summary of learning outcomes
1. Describe the key sources of income and expense of a (re)insurance company.
2. Explain the purpose of the technical underwriting accounts.
3. Explain what key information can be found in the profit and loss account of a (re)insurer.
4. Explain the importance and relevance of items that make up the balance sheet.

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At the heart of insurance accounting lies a conundrum: how to account for the inherent uncertainties associated with unknown or not fully developed liabilities that can be difficult to quantify. The revenue or turnover of an insurer is relatively certain but due to the delayed nature of losses, it can be difficult to strike a profit. To exacerbate this challenge further, accounting standards are moving away from the principle of prudence thereby creating greater volatility of results. This area of material uncertainty is a reoccurring theme throughout this unit

It must be noted that different domiciles and different captives will have specific requirements (depending upon which accounting standards they have adopted e.g. International Financial Reporting Standards ("IFRS") and this module does not seek to address anything other than a very general guidance as to the type of accounting principles which are likely to be applicable. It should also be noted that the actual accounts produced by the captive may look quite different as they will be prepared in a certain prescribed format and will include significant disclosures, this module is merely intended to give the reader a basic idea of the concepts involved. We have included a set of statutory audited accounts for a captive insurance company in the appendices so that you can see how these are typically presented.

Accounting Standards and requirements are constantly changing as rules are amended by the International Financial Standards committees who are seeking to standardise accounting rules across the globe wherever possible.

It is recommended that you access a recent copy of a set of financial year end, audited, statutory accounts of a captive and review these to see how accounting standards are applied and represented in statutory accounts and the notes thereto.

12.0 INCOME AND EXPENSE SOURCES

The main areas of captive income and expense can be summarized as follows:

12.0.1 Income

Premium

Reinsurance ceding commission from outgoing reinsurance

Reinsurance profit commission (often allowed based on profit of outgoing reinsurance)

Investment income from:

- Capital and reserves
- Annual cash flow
- Claims reserves
- Loan interest from the Parent Company

12.0.2 Expenses

Underwriting

- Fronting fees/commission
- Brokerage
- Premium/withholding taxes
- Reinsurance premiums

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- Claims (incurred and IBNR)
- Loss adjuster fees and legal expenses
- Engineering and other loss prevention fees
- Actuarial fee

General and Administration

- Management fees
- Directors' fees
- Audit fees
- Investment advisory fees
- Travel and entertainment
- Bank charges
- General sundry
- Formation costs and other occasional legal or consultancy expenses

These, of course, are little different from the accounts of a traditional insurer save that the general and administrative expenses will typically represent a much smaller percentage of the incoming premium.

12.1 TECHNICAL ACCOUNTS

Often, as well as the general (non-technical) profit and loss account, there will be one or more technical accounts produced for management reporting. Some domiciles require technical underwriting accounts to be shown separately in the statutory financial statements and for the investment income relating to insurance activity to be allocated and split out from the investment income earned on shareholders' funds.

The technical underwriting accounts may be a combination of a variety of lines of business although it would not be unusual to split between long-tail business (e.g. public and employer's liability) and short-tail business (e.g. property and motor insurance). Alternatively separate technical underwriting accounts can be produced for each line of business written and this will be particularly seen in the management information produced for review by the board of directors (even though normally this level of detail would be omitted from the statutory accounts in favour of one consolidated technical account).

On the income side the premiums written would be the gross premiums received from the insured on direct business or ceded from an insurance company if the business is fronted. Not all of the policies may have a renewal date coterminous with the financial year of the company and therefore, as only part of the premiums will be earned in the financial year, a proportionate reserve has to be made to hold back earning that income until the next financial year. Thus, the unearned premium reserve in the balance sheet represents deferred income and as in this example the indication is that a new policy incepted mid-way through of the financial year.

This then produces the premiums earned in the financial period, from which reinsurance premiums and any commissions / fees paid should be deducted to show the net income. The commissions and taxes line would include the fronting fees paid to the ceding company, insurance premium tax and any other taxes and expenses incurred by the captive according to the percentage of risk it was writing. This would also include any local brokerage paid.

Reinsurance premiums and commissions / fees are earned so as to match the earning of the underlying insurance premium.

The losses paid and recoverable figures are self-explanatory but so far as the reserves are concerned (both reported and Incurred But Not Reported IBNR) the financial result shows the increase or decrease in these according to how they stood in the balance sheet at the beginning and end of the year. For example, the movements in the example below are actually made up of reserves for the current year, plus movements in 2020 and 2019 so only the net effect of these is added to the reserves in the balance sheet applicable to the 2021 financial year. The same applies to the claim recoveries due from reinsurers.

Technical account for underwriting

	Total	2021	2020	2019
Gross premiums written	9,406,367	8,264,910	1,141,457	-
Commission	(231,563)	(147,260)	(84,303)	-
Outward reinsurance premiums	(4,040,018)	(3,954,629)	(85,389)	-
Net premiums written	**5,134,786**	**4,163,021**	**971,765**	**-**
Change in provision for unearned premiums	99,761	(3,715,561)	3,815,322	-
Change in provision for unearned reinsurance premiums	98,480	1,607,897	(1,509,417)	-
Net earned premiums	**5,333,027**	**2,055,357**	**3,277,670**	**-**
Claims paid	(11,138,898)	(591)	(1,351,194)	(9,787,113)
Reinsurers' share	9,854,966	-	-	9,854,966
Change in the provision for claims				
Outstanding claims	8,793,497	(30,000)	(10,578)	8,834,075
Reinsurers' share	(8,384,594)	-	-	(8,384,594)
Change in IBNR provision	(1,347,586)	(1,609,167)	(471,563)	733,144
Total losses incurred	**(2,222,615)**	**(1,639,758)**	**(1,833,335)**	**1,250,478**
Net underwriting income	**3,110,412**	**415,599**	**1,444,335**	**1,250,478**

Investment income (not included in this example):
Where investment income is included in the technical account it is, to some extent, fairly arbitrary because few captives would segregate investments of the underwriting funds from shareholder's funds. Nevertheless, based on average returns and funds available it is possible to arrive at a realistic estimate of the investment income derived from the underwriting function. As has previously been stated, this can be an important aspect of the underwriting decision in that the investment income on retained premium and claims reserves, particularly for long-tail business, can be a significant part of the overall income such that the business can sometimes be written at loss ratios in excess of 100%. This becomes of relevance when interest rates are high and investment returns can be material.

12.2 DIFFERENCE BETWEEN FINANCIAL ACCOUNTS AND UNDERWRITING STATISTICS

It is important to distinguish between financial accounts and underwriting statistics. The financial accounts are the annual results of the company and are an accumulation of all of the company's financial transactions during that particular financial year. At the end of the financial year, reserves are included for known income and expense and provision is made for unknown items on a best estimate basis such that the year-end financial statement shows a true and fair view of the profit of the company and its financial position at the close of that particular financial accounting period. Once audited these accounts are then, in effect, fixed. Thus, should the loss reserves included in these financial accounts subsequently be settled at a different figure, the adjustment, be it a profit or a loss, will be shown in the financial accounts in the year in which the claim is actually settled or the reserve adjustment took place.

This compares with the underwriting statistics which remain open and are constantly being refined until the underwriting year is closed. The last three columns of the underwriting technical account above, show how this principle works and how the financial result for the Year 2021 has been derived from transactions relating to the three previous underwriting years. A considerable part of the profit has been derived from the earlier underwriting years, partly by a conservative reserving policy but more

particularly by extra income coming in, presumably from premium adjustments. It can be very difficult to estimate future premium adjustments and it is not unreasonable to ignore recording them until the year in which the actual figure is reported. They tend to have more direct effect on the profit as compared to current premium in that they are for past years of account for which claim reserves have already been established and thus any additional income or expense tends to flow straight through to the profit line. An analysis of the accounts such as shown in the example is important in that, apart from showing the result for the current financial year it gives an indication of how effectively the company is reserving for claims. Had the previous years' underwriting statistics shown negative figures it would have indicated that profits had been overstated as a result of over reserving income and/or under reserving losses and corrective action might need to be taken.

The net results of technical account for underwriting are used to create the Technical Account in the statutory financial accounts as shown in the example below:

12.2.1 Technical Account: An Example

Statement of Comprehensive Income
Technical Account – General Business
for the year ended 31 December 2021

		Year ended 31 December 2021		Year ended 31 December 2020	
	Note	**€**	**€**	€	€
Earned premiums, net of reinsurance					
Gross premiums written	*x*	**9,406,367**		9,294,151	
Commission		**(231,563)**		(434,669)	
Outward reinsurance premiums	*x*	**(4,040,018)**		(3,669,285)	
			5,134,786		5,190,197
Change in provision for unearned premiums	*x*	**99,761**		(29,821)	
Change in provision for unearned reinsurance premiums	*x*	**98,480**		(467,519)	
			198,241		(497,340)
Net earned premiums			**5,333,027**		4,692,857
Claims incurred	*x*				
Claims paid		**(11,138,898)**		(6,118,777)	
Reinsurers' share		**9,854,966**		3,867,893	
Claims expenses		**(64,620)**		(64,800)	
Reinsurers' share of claims expenses		**64,620**		64,800	
Total claims incurred			**(1,283,932)**		(2,250,884)
Change in the provision for claims					
Outstanding claims		**8,793,497**		3,386,936	
Reinsurers' share		**(8,384,594)**		(4,237,600)	
Change in IBNR provision		**(1,347,586)**		(558,021)	
Total increase in provision for claims			**(938,683)**		(1,408,685)
Underwriting profit transferred to non-technical account			**3,110,412**		1,033,288

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12.3 PROFIT AND LOSS ACCOUNT

Below we show an example profit and loss account, also referred to as Statement of Comprehensive Income or Income Statement. Where technical accounts are included, the profit and loss account can be simplified such that they will show, a “transfer from technical accounts” rather than details of the underwriting income and underwriting expense as shown in the previous example. Sometimes, particularly in those areas where the regulations require the production of technical accounts, the investment income is struck before the underwriting profit so that the only investment income shown in the profit and loss account will be that relating to shareholders’ funds.

General and administration expenses would usually be itemised in detail for management account purposes, as in the example below, but could be shown as one line item as would normally be the case in statutory accounts. This detail is essential management information for the directors but it is of no concern to, for example, any fronting company or reinsurer who may require a copy of the captive insurance company’s accounts to check security.

Foreign exchange gain or loss is something that invariably appears in the profit and loss account of a captive insurance company where the captive transacts in a variety of currencies. Due to potential fluctuations in exchange rates it is good practice for the captive to retain only foreign currency funds sufficient to meet its liabilities in those currencies, i.e. to meet claim payments. Some companies keep the annual premium in the original currency until the close of the insurance year and convert any balance at expiry of the policy but the effect is roughly the same. Thus, the aim is to hold only foreign currency funds approximating to the claim reserves in those currencies. It follows, therefore, that if there is a movement in the exchange rate which increases the value of the loss reserves it has the same effect of increasing the value of the funds in the bank accounts in those currencies, set up to meet those claims, and vice versa, and serves to balance an increase or reduction in the loss reserve. The exchange gain or loss shown is frequently an unrealised amount which may be eliminated when the claim is ultimately settled. Clearly this is not an exact science and there can be exchange gains and losses over and above claim reserves but they should be relatively minor and not materially impact the insurer’s results.

Statutory accounts for the current period would, as in the example, be shown alongside the results for the prior year. In management accounts and particularly quarterly accounts produced for to the board, there might also be included results for the previous month or quarter, the year to date, comparison with budget and/or latest forecast of the year’s result as well as comparison with the prior year figures. This is all for the board’s information and there is no hard and fast rule as to what should be produced other than in the statutory accounts where prior year results must be shown.

12.3.1 Profit and Loss Account for Period ended 31 December 2021

Statement of Comprehensive Income (continued)
Non-technical account
for the year ended 31 December 2021

	Notes	Year ended 31 December 2021 GBP		Year ended 31 December 2020 GBP
Transfer from technical account		**3,110,412**		1,033,288
Income	*x*			
Gain on foreign exchange		**267,329**		-
Investment income	*x*	**5,224**		3,058
Bank interest		**64**		149
		3,383,029		1,036,495
Expenses	*x*			
Management fees		**(52,558)**	(51,807)	
Directors' fees		**(6,537)**	(6,410)	
Auditor's remuneration		**(21,684)**	(12,797)	
Loss on foreign exchange		**-**	(101,478)	
Statutory fees		**(7,132)**	(6,870)	
Sundry expenses		**(1,465)**	(4,402)	
Total administrative expenses		**(89,376)**		(183,764)
Profit for the year		**3,293,653**		852,731

12.4 BALANCE SHEET

The example below shows the items typically included in the balance sheet also referred to as Statement of Financial Position.

- Non-current assets:

The example below includes the reinsurer's share of technical provisions as non-current assets as generally these items can take longer than a year to realise.

- Current assets:

Cash and cash equivalents are usually shown separately from investments, the thinking being that the former represents the liquid funds and the latter medium to longer term investments although this is not always the case.

Amounts due from reinsurers, be they for claims recoveries, premium return or profit commission, will be included when known, along with premiums receivable from the fronting company or the insured.

- Current liabilities:

Reinsurance balances payable would usually bear some relationship to premiums receivable. Just as pre-paid expenses are included as an asset so accrued expenses, for services such as the audit fees or directors' fees paid in arrears, would be included as a liability. Depending on the domicile of the captive there may be some taxation payable and a dividend, declared by the board, may not yet have been paid and therefore remains a liability.

- Premium and claims provisions:

The premium and claims provisions are usually shown separately from other current liabilities and shown as technical reserves as they may relate to amounts due in excess of one year. These show the accumulated totals of unearned premium, reserves for reported loss and IBNR reserves. This compares with the profit and loss account which shows the movements in these totals for the year.

The total of liabilities is deducted from the assets to arrive at net assets which equal the shareholders' equity, which is usually made up of share capital and retained earnings. Some balance sheet presentation now show the assets as one half and the liabilities and shareholders' funds in the other half, the two totals equaling each other as in the example below.

The material items in the balance sheet would usually relate to the cash and investments compared with the underwriting liabilities. The directors need to ascertain what are the underwriting liabilities and whether they are appropriately reserved, whether there are enough free reserves (cash and investments) to meet these liabilities and are these investments reasonable bearing in mind the timescale to meet the liabilities, i.e. if the underwriting liabilities are likely to need to be met in the short-term, one would be looking for sufficient assets that could be realised in a short time frame.

12.4.1 Balance Sheet: An Example

Statement of Financial Position
at 31 December 2021

	Note	2021		2020	
		GBP	**GBP**	GBP	GBP
ASSETS					
Reinsurers' share of technical provision					
Unearned reinsurance premiums provision		**1,607,896**		1,509,416	
Outstanding claims		**1,964,441**		10,349,035	
			3,572,337		11,858,451
Current assets					
Investments	*x*	**29,602,037**		30,521,658	
Cash and cash equivalents		**4,257,786**		3,446,085	
Accrued interest receivable		**8,432**		3,207	
Premiums receivable		**1,571,128**		2,358,848	
Claims recoverable		**5,187,396**		216,541	
Other debtors and prepayments		**93,939**		87,683	
			40,720,718		36,634,022
Total Assets			**44,293,055**		48,492,473
EQUITY AND LIABILITIES					
Capital and reserves					
Called up share capital	*x*	**168,192**		168,192	
Share premium account	*x*	**672,768**		672,768	
Profit and loss account		**26,246,931**		22,953,278	
Equity Shareholders' funds			**27,087,891**		23,794,238
Technical provisions					
Unearned premium provision	*x*	**3,715,561**		3,815,322	
Outstanding claims	*x*	**4,540,534**		13,334,031	
IBNR provision	*x*	**4,896,453**		3,548,867	
		13,152,548		20,698,220	
Creditors					
Reinsurance premiums payable		**3,804,629**		3,587,613	
Claims payable		**-**		-	
Accrued expenses	*x*	**247,987**		412,402	
Total liabilities			**17,205,164**		24,698,235
Total liabilities and equity shareholders' funds			**44,293,055**		48,492,473

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12.5 BUDGETS

Captives, with their relatively narrow portfolio and potential annual variability of losses, present challenges when it comes to budgeting. In the traditional insurance world, with a wider range of businesses dampening volatility, variances often fall within an acceptable range. But the captive's results may deviate from plan to an extent unacceptable to a parent group used to predictable profit deriving normally as a % of turnover. It thus has to be recognised by the parent that the potential variability within the captive will be larger (and entirely dependent upon claims reported) than say a manufacturing subsidiary.

Nevertheless, realistic budgets can be produced. The starting point might be the budget produced by the group risk manager who will be aware of the premiums he is forecasting will be offered to the captive, relative to those risks going through to the captive. On the assumption the captive will be underwriting the risk at break even or at a modest profit, it would be appropriate for the captive to be establishing loss provisions in line with those same premium levels. Obviously if there is to be any change in the arrangements relative to the captive it is incumbent upon the group risk manager, who would usually be responsible for the captive budget at parent level, to advise any variations to the manager at budget time. Claim levels can be based on past loss information and as organisations tend to accept positive variances more favorably than negative ones, a conservative approach (i.e. 100% loss ratio) should be taken when predicating claim levels. Investment income should be a relatively straightforward calculation with the returns being a mixture of the interest rate being assumed by the parent compared with the existing captive investment portfolio. After provision of other income and expenses the total budget should then be reviewed to see how it compares with the prior years and whether it truly reflects potential trends.

Some smoothing of results can take place within management accounts throughout the year. Should a quarter produce a higher than expected profit, the IBNR provision can be adjusted to bring the result down to budget level and providing a buffer that can be released should subsequent quarter results be below budget. In effect the IBNR reserve is being used as a profit smoothing mechanism during the financial year

Where the actual results are showing a significant variability from budget it is incumbent upon the accounting personnel to reforecast the results for the current year. Thus, it is not uncommon when reviewing management accounts to see, compared with the current result, columns showing the previous year, the budget and the latest forecast.

12.6 BANK ACCOUNTS

A captive will need to open one or maybe a number of bank accounts according to its business needs and investment programme. Usually, it will need a current account in its domicile to meet its normal running expenses and it may require current accounts in a variety of currencies according to the territories in which it is doing business, for the receipt of premium and payment of claims.

Alongside the current accounts there may be a need to open deposit accounts according to the investment programme. Even when investment managers are used there might still be considerable funds placed as cash investments to meet cash flow needs.

The bank mandates, specifying who can authorise payments, would be ideally agreed by the board at its initial meeting. There would usually be two schedules of signing authorities one being a list of the manager's personnel who can sign on behalf of the company and the other the list of directors. The manager's personnel would usually be allowed to settle any amounts under, say, £10,000 or currency equivalent, upon two signatories of the management company. Additionally, there may be a list of

payees comprising the parent group's subsidiaries, fronting insurers, reinsurers and brokers to whom regular large payments can only be made. Any payments to these listed payees would also be allowed by two signatures solely from the managers. All other payments require a signature from a director plus one signature from the manager. It is not considered good practice for two directors to be able to make any payments without also a signature from the manager. The manager is able to better monitor the liquidity and solvency of the captive as the appointed General Representative and will have to be in a position where the parent company directors on the captive board are unable to direct elsewhere funds that are required to meet claims and expenses. There are examples of parent companies becoming insolvent with the only solvent subsidiary being the captive – a plaudit to regulation and sensible signing authorities.

12.7 CURRENCY RISKS

It is often thought that a captive dealing with a variety of countries and currencies runs a significant currency risk. In practice this is normally not so.

The normal procedure is for premiums to be received and the appropriate portion paid to reinsurers in original currency. It is also usual for the reinsurance treaty to pay claims in original currency even though the treaty itself may be designated in a single currency. The currency of the treaty would usually be the base currency of the captive.

The following example using obviously fictitious exchange rates for the purposes of explanation shows what happens. It is based on a German subsidiary of a UK parent:

A.	Total insured value on day one of policy	EUR 500,000
		= US $ 250,000
		= £STG 170,000
B.	Claim occurs on day 364	EUR 500,000
		US $ 275,000
		£STG 200,000
	Captive retention	£100,000

- Reinsurance placed excess of captive retention which is fixed in sterling regardless of local currency.

- Only risk to captive is minor variations within retention. No effect on large claims viz.

Total loss under A	=	£100,000
Total loss under B	=	£100,000

- Percentage difference on small claims wholly within captive retention is the same as the exchange difference so **maximum** in this example is 17.6 % (£170,000 to £200,000) but maximum exposure to the captive is only £15,000, i.e. £85,000 plus 17.6% becomes £100,000.

It would be a risky practice for a captive to reinsure, pay premium and receive claims in a single currency when it was itself receiving premium and paying claims in a variety of currencies. The captive would be carrying more currency risk than is shown in the above example by virtue of the fact that the timing of premium receipt in different currencies would not be the same as the timing of payments to or from reinsurers. Equally, reinsurers' payments on claims would be received at

different times whereas only a single payment is likely to be made to the insured on an agreed date in the currency of the claimant. As stated relative to investments, it is not advisable for a captive to speculate in currencies.

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Self-test questions

Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text.

1. What is the purpose of an unearned premium reserve in the accounts?
2. Explain the main difference between financial accounts and underwriting statistics?
3. Why might there be foreign exchange gains or losses shown in the accounts of an (re)insurance company?
4. What are the most material items to consider when looking at the balance sheet of an (re)insurer?

Summary of learning outcomes
1. Describe the key sources of income and expense of a (re)insurance company.
2. Explain the purpose of the technical underwriting accounts.
3. Explain what key information can be found in the profit and loss account of a (re)insurer.
4. Explain the importance and relevance of items that make up the balance sheet.