Institute of Chartered Accountants of New Zealand

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FINANCIAL REPORTING OF INSURANCE ACTIVITIES

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This Financial Reporting Standard should be read in the context of the Explanatory Foreword to General Purpose Financial Reporting published by the Council, Institute of Chartered Accountants of New Zealand.

The Accounting Standards Review Board has approved FRS-35: Financial Reporting of Insurance Activities, for the purposes of the Financial Reporting Act 1993, to apply to the following persons (as respectively defined in the Act): All reporting entities and groups, the Crown and all departments, Offices of Parliament and Crown entities and all local authorities.

1 INTRODUCTION

COMMENTARY

1.1 This Standard deals with financial reporting of insurance activities.

1.2 Financial reporting standards are paragraphs in bold type-face in this Standard. Where appropriate, interpretative commentary paragraphs in plain type-face follow the financial reporting standards.

2 APPLICATION

STANDARD

2.1 This Standard applies to the general purpose financial reports of entities that undertake insurance or reinsurance activities, other than life insurers as defined in FRS-34: *Life Insurance Business*.

COMMENTARY

2.2 General purpose financial reports include interim financial reports. For the purposes of FRS-24: *Interim Financial Statements* the determination of liabilities for outstanding claims in accordance with paragraphs of this Standard does not necessarily require a full actuarial valuation. The liabilities for outstanding claims shall be determined on a reliable basis, including a review of assumptions, and not be materially different from liabilities for outstanding claims determined by a full actuarial valuation.

STANDARD

2.3 In the event of a conflict between this Standard and any other Standard, the requirements of this Standard prevail.

2.4 The financial reporting standards set out in this Standard apply to financial reports where such application is of material consequence. A

statement, fact, or item is material if it is of such a nature or amount that its disclosure, or the method of treating it, given full consideration of the circumstances applying at the time the financial reports are completed, is likely to influence the users of the financial report in making decisions or assessments.

2.5 This Standard applies to general purpose financial reports covering periods beginning on or after 1 July 1999.

3 STATEMENT OF PURPOSE

COMMENTARY

3.1 The purpose of this Standard is to:

(a) specify the manner of accounting for the insurance activities of an entity and for the investment activities integral to those insurance activities; and

(b) require disclosure of information relating to insurance activities so that users of general purpose financial reports are provided with information about the financial position and performance of the entity.

3.2 There are various types of insurance. This Standard deals with insurance (including reinsurance) activities, other than those carried on by life insurers as defined in FRS-34: *Life Insurance Business*.

3.3 Insurance provides protection for a specified period against specified losses resulting from the occurrence of specified types of events that may occur. Such events include theft, earthquakes or storms resulting in property loss or damage, accidents resulting in injury, sickness (medical insurance), death during a specified period (term life insurance), payment default (consumer credit insurance), failure of an item under an extended warranty, and fires or floods resulting in interruptions to business. For certain amounts of premium, the insurer undertakes to accept, either wholly or in part, from the insured the risks of sustaining specified losses arising from such events within a specified period. For many types of insurance business, such as fire and fire-related risks, the specified period is usually one year. For other types of insurance business, the specified period relates specifically to the underlying risk, which may be a period less than one year (for example, marine cargo insurance), or a period of many years (for example, mortgage insurance).

3.4 This Standard does not deal with accounting by life insurers, because such accounting is subject to the application of FRS-34: *Life Insurance Business*. Life insurance is normally an assurance that a benefit will be paid on the occurrence of a specified event that will definitely take place, but the timing of which may be uncertain.

3.5 This Standard applies to the general purpose financial reports of captive insurers.

3.6 This Standard does not deal with accounting for self-insurance, which is an entity's decision not to transfer to an insurer a risk that could have been covered by insurance. With self-insurance there is no insurance contract because there is no agreement with another party. However, the principles adopted in this Standard for measuring the liability to external parties in respect of outstanding claims are appropriate for measuring liabilities to external parties resulting from self-insurance.

4 DEFINITIONS

STANDARD

The following terms are used in this Standard with these meanings:

4.1 "Attachment date" (sometimes referred to as "inception date") is, for a direct insurer, the date from which the insurer accepts risk from the insured under an insurance policy or endorsement or, for a reinsurer, the date from which the reinsurer accepts risk from the direct insurer or another reinsurer under a reinsurance arrangement.

4.2 "Claim" is a demand by any party external to the entity for payment by the insurer of a policy benefit on account of an alleged loss resulting from an event or events alleged to be covered by a policy of insurance.

4.3 "Deposit premium" is the premium charged by the insurer at the inception of a policy under which the final premium depends on conditions prevailing over the policy period and so is not determined until the expiry of that period.

4.4 "Insurance contract" is a contract under which one party (the insurer) agrees with another party (the policyholder) to make payment if a specified uncertain future event occurs.

4.5 "Investments" are assets held by an entity for the accretion of wealth by way of revenues such as interest, royalties, dividends, rentals and capital appreciation, but do not include operating assets.

4.6 "Investments integral to the entity's insurance activities" are investments controlled by the entity in the conduct of its insurance activities.

4.7 "Long-tail business" is insurance business under which claims are typically not settled within one year of the occurrence of the events giving rise to those claims.

4.8 "Net claims incurred" are direct claims costs, net of reinsurance and other recoveries, and indirect claims settlement costs, all determined on a discounted basis.

4.9 "Net market value" is the price for which an asset might reasonably be expected to be sold at a particular date in an orderly market, less the costs of disposal that could reasonably be anticipated at that date.

4.10 "Premium" is the amount charged in relation to accepting risk from the insured, but does not include amounts collected on behalf of third parties.

4.11 "Short-tail business" is insurance business under which claims are typically settled within one year of the occurrence of the events giving rise to those claims.

5 FINANCIAL REPORTING

Premiums

STANDARD

5.1 Premium revenue must be recognised from the attachment date as soon as the amount of the premium can be reliably measured.

COMMENTARY

5.2 The amount of a premium is determined by an insurer so as to cover anticipated claims, reinsurance premiums, administrative, acquisition and other costs, and a profit component (having regard to expected revenues from the investment of premiums). The amounts collected in respect of these components are revenue of an insurer on the basis that they are collected in consideration for the insurer rendering services by indemnifying those insured against specified losses.

5.3 For certain classes of insurance business, government authorities may require the payment of levies and charges. Examples include levies imposed under the Accident Insurance Act 1998 to reimburse the non-compliers and insolvent insurers funds (accident insurance levies), earthquake commission premiums and fire service levies. Some such levies and charges, such as accident insurance levies, are expenses of the insurer, rather than government charges directly upon those insured. The insurer is not acting simply as a collector of these levies and charges. Although not compelled to collect these amounts from those insured, the insurer may include in premiums an amount to cover the estimated amount of the levies and charges. The insurer is usually responsible for paying the levies and charges at a later date. The amount paid by the insurer does not depend on the amounts collected from those insured in relation to the levies and charges. Therefore, the amounts collected to meet these levies and charges are revenue of the insurer. Other levies and charges, such as earthquake commission premiums and fire service levies, are not included in the definition of premium as the insurer is acting simply as a collector.

5.4 Some insurers employ the services of a third party to sell insurance policies and collect the premiums from the insured on their behalf. This third party may also perform other functions, such as claims handling. The third party pays the insurer a net amount, being the gross premiums collected, less commissions and other expenses or fees. In these circumstances, the third party does not underwrite risk under the insurance policies and is acting as an agent for the insurer. The insurer should recognise the gross premium as revenue and any commissions and claims handling costs as expenses in accordance with this Standard.

5.5 In some circumstances, however, policies may be issued by intermediaries who are themselves responsible for setting the final amount payable by the insured without reference to the insurer. In such circumstances, the written premium will normally comprise the premium payable to the insurer and the grossing-up will be inappropriate unless it reflects the contractual position.

5.6 Where premium revenue is receivable by instalments during the period of risk covered by the insurance contract, any outstanding amount at the end of the reporting period to which the insurer is contractually entitled should be treated as a debtor.

5.7 Premium revenue should be recognised from the date of the attachment of risk in relation to each policy of insurance because insurers assume risks from that date on behalf of those insured. However, for reasons of practicality, many insurers use bases of recognition that attempt to approximate this date. These bases are predicated on assumptions; for example, a direct insurer may assume that risk attaches to all policies from the middle of the month in which they are written, and a reinsurer may assume, in relation to premiums ceded to it, that risk attaches from the assumed attachment date of the underlying direct insurance policies or of the indemnity periods. Such bases are acceptable provided that they do not result in the recognition of a materially different amount of premium revenue in a particular reporting period than would be the case if recognition occurred from the date of attachment of risk for each policy.

STANDARD

5.8 Over the period of insurance, premium revenue must be recognised in the entity's statement of financial performance in accordance with the pattern of the incidence of risk or, where the result will not be materially different, evenly over the period of the policy (for direct insurance), or period of indemnity (for reinsurance).

COMMENTARY

5.9 The gross written premium for a reporting period would normally not equate with premium revenue because the gross written premium would normally include cover of a pattern of risk to which the insurer is exposed beyond the reporting date. These amounts would be recognised as revenue by the insurer in the subsequent reporting period or periods over the remaining duration of the insurance policies.

5.10 Because insurers assume risks on behalf of those insured, the recognition of premium revenue over the period of a policy of insurance should be based on the pattern of risk to which the insurer is exposed. An insurer may be able to reliably estimate the pattern of risk for a particular type of insurance business based on past experience.

5.11 Most insurers recognise premium revenue on the basis of the passage of time. Time apportionment is normally appropriate unless there is a marked unevenness in the incidence of risks over the period of cover which leads to a material difference in the recognition of premium revenue.

STANDARD

5.12 In the case of business where the premium is subject to later adjustment, the adjusted premium must be used, where possible, as the basis for recognising premium revenue. Where this is not possible, the deposit premium adjusted for any other relevant information must be recognised as the premium revenue provided that it is expected that this amount will not be materially different from the actual amount of premium.

COMMENTARY

5.13 For some classes of insurance it is usual for the premium to be adjusted as a result of events and information that only become known during or after the policy period. For example, marine cargo insurance is a type of "adjustable" business for which a deposit premium at the beginning of the policy period and subsequently adjusted on the basis of a cargo declaration. Some reinsurance arrangements also typically involve the ceding of an amount of deposit premium, which is subject to subsequent adjustment based on the outcome of the covered insurance policies.

5.14 Where the precise amount of premium revenue is uncertain, insurers often estimate the amount of the premium using the deposit premium adjusted for any other relevant information that may be available, such as the recent claims experience under adjustable-premium policies. Where such estimates and the actual (adjusted) premiums are not expected to be materially different, this approach provides a reliable basis for measuring premium revenue.

STANDARD

5.15 Premium revenue relating to unclosed business must be recognised in accordance with the standards set out in paragraphs 5.1, 5.8 and 5.12.

COMMENTARY

5.16 Frequently, there is insufficient information available at the end of a reporting period to enable an insurer to accurately identify the business written close to the reporting date for which the date of attachment of risk is prior to the reporting date. This is often referred to as unclosed business. Consistent with the principle stated in paragraph 5.1 that premium revenue is to be recognised from the

attachment date, all unclosed business should be estimated and the earned portion of premium relating to unclosed business included in premium revenue.

5.17 Estimates of the amount of unclosed business can be made using information from prior periods adjusted for the impact of recent trends and events. In addition, information about unclosed business may become available between the reporting date and the date of completion of the financial report that may enable more reliable estimates to be made.

Claims — Recognition and Measurement

STANDARD

5.18 A liability for outstanding claims must be recognised in respect of both direct business and inwards reinsurance business and must be measured as the present value of the expected future payments.

COMMENTARY

5.19 The liability for outstanding claims should be measured as the present value of expected future payments. This requires estimation of the ultimate cost of settling claims and the discounting of those amounts to a present value. The amount recognised as the liability for outstanding claims is to be the estimate of the expenditure required to settle the present obligation at the reporting date. The risks and uncertainties that inevitably surround claims are to be taken into account in reaching the best estimate of the outstanding claims liability.

5.20 Caution is needed in making judgements under conditions of uncertainty. However, uncertainty does not justify the deliberate overstatement of the outstanding claims liability. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then to be deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of the outstanding claims liability.

5.21 The longer the expected period from the reporting date to settlement, the more likely it is that the ultimate cost of settlement will be affected by inflationary factors likely to occur during the period to settlement. These factors include for example, changes in specific price levels, trends in average periods of incapacity and in the amounts of court awards for successful claims.

5.22 For claims expected to be settled shortly after balance date, including those arising under short-tail business, the impact of discounting may not be material. Where this is so, the liability for such claims may be measured as the amount of the expected future payments.

5.23 Where previous insurers have either contributed to or are expected to contribute to the claim, the claims expense and the liability for outstanding claims should be recognised gross, before those contributions. For example, such

contributions can arise for accident policies on gradual process claims, or claims that are exacerbated by previous injuries, when another insurer or insurers insured the employee. In these circumstances, the current insurer is primarily responsible under the legislation for making all payments to the claimant. While the current insurer is entitled to claim from other contributing insurers, there is no right of set-off, as defined in FRS-27: *Right of Set-off*. It is therefore inappropriate to report the claims expense and liability net. Other contributing insurers are to recognise their obligations for such contributions in accordance with paragraph 5.18, as part of their liability for outstanding claims.

Claims — Expected Future Payments

STANDARD

5.24 The expected future payments must include amounts in relation to unpaid reported claims, claims incurred but not reported, adjustments in the light of the most recently available information for claims development and claims incurred but not enough reported, and costs that the insurer expects to incur in settling these claims.

COMMENTARY

5.25 The estimate of the outstanding claims liability is ultimately determined by the judgement of the management and the governing body of the entity, supplemented by experience of similar transactions and reports from independent experts such as actuaries. The evidence considered includes actual experience and any additional evidence provided by events after balance date. Future events that may affect the amount required to settle a particular outstanding claims liability are only to be included where there is sufficient objective evidence that they will occur.

5.26 It is important to identify the components of the ultimate cost to an insurer of settling claims, for the purposes of determining the claims expense for the reporting period and determining the liability for outstanding claims as at the reporting date. These components comprise the policy benefit amounts required to be paid to or on behalf of those insured, and claims settlement costs, that is, costs associated with achieving settlements with those insured. Claims settlement costs include costs that can be associated directly with individual claims, such as legal and other professional fees, and costs that can only be indirectly associated with individual claims, such as claims administration costs.

5.27 Policy benefit amounts and direct claims settlement costs incurred during the reporting period are expenses of an insurer, representing the consumption or loss of economic benefits. The liability for outstanding claims includes unpaid policy benefits and direct claims settlement costs relating to claims arising during the reporting period, as they are outgoings that an insurer is presently obliged to meet as a result of past events.

5.28 Indirect claims settlement costs incurred during the reporting period are also expenses of an insurer, and include a portion of the indirect claims settlement costs to be paid in the future — that which relates to handling claims arising during the reporting period. The liability for outstanding claims includes these unpaid indirect claims settlement costs.

5.29 It is important to ensure that claims are recognised as expenses and liabilities in the correct reporting period. Claims arise from events covered by policies of insurance that occur during the period of the policies. Some events will occur and give rise to claims that are reported to the insurer and settled within the same reporting period. Other reported claims may be unsettled at the end of a particular reporting period. However, there may also be claims incurred but not reported (IBNR) at the end of the particular reporting period. This includes events which have occurred and will give rise to claims but have yet to be reported at the end of the reporting period and events which are occurring which will give rise to a claim in the future, such as gradual process injuries developing in the workplace.

5.30 Claims arising from events that occur during a reporting period and which are settled during that same period are expenses of that period. In addition, a liability and corresponding expense should be recognised for reported claims arising from events of the reporting period which have yet to be settled. This involves a process of estimation which includes assessment of individual claims and past claims experience.

5.31 When, based on knowledge of the business, claims IBNR are expected to exist, an estimate should be made of the amount of the successful claims that will arise therefrom. This involves recognition of a liability and corresponding expense for the reporting period. As in the case of reported but unsettled claims, an estimate of the amount of the current claims incurred but not reported should be based on past experience and should take into account any changes in circumstances, such as recent catastrophic events and changes in the volume or mix of risks underwritten, that may affect the pattern of unreported claims.

5.32 The recognition as expenses and liabilities of the components of the ultimate cost of settling claims also depends on whether they can be measured reliably. Some insurers use formulae, related to the amount of outstanding claims and based on the past experience of the insurer and the industry, to arrive at an estimate of direct and indirect settlement costs. Provided that such formulae are based on a reasonable number of years and are appropriately adjusted to take account of recent developments, they would normally provide a reliable estimate of the settlement costs.

5.33 The claims expense and the liability for outstanding claims are to be reassessed at each reporting date and adjusted on the basis of information, including re-opened claims, that becomes available after the initial recognition of claims, to enable the insurer to make a more accurate estimate of the ultimate cost of settlement. This is often referred to as claims development. As is the case with

other liabilities, the effect of the adjustments to the liability for outstanding claims and to claims expense should be recognised through the statement of financial performance when the information becomes available.

5.34 Where further information becomes available about reported claims and reveals that the ultimate cost of settling claims has been under-estimated, the upwards adjustment to claims expense and to the liability for outstanding claims is often referred to as claims incurred but not enough reported (claims IBNER). Where further information reveals that the ultimate cost of settling claims has been over-estimated, the adjustment is sometimes referred to as negative claims IBNER.

Claims — Discount Rate

STANDARD

5.35 The discount rate(s) to be used in measuring the present value of the expected future payments must be the risk free rate(s) which is(are) appropriate to the future period or periods over which the payments are expected to be made.

COMMENTARY

5.36 Among the key assumptions underlying the present value measurement of expected future payments is the discount rate used in discounting expected future cash flows. The general principle emerging from international accounting developments is that, in the absence of a market determined fair value, the stream of expected future cash flows should be discounted at a rate that reflects the risks inherent in that cash flow stream. The use of the risk free rate is currently the most appropriate option given the nature of the liabilities to be discounted and the general principle arising from international accounting developments. However, the International Accounting Standards Committee has currently underway a project on accounting for insurance and the Financial Reporting Standards Board intends to revisit the discount rate for insurance once an international consensus is reached.

5.37 The appropriate risk free rate(s) to be used should be the forward rate(s) derived from observed market yields at the date of the valuation for maturity dates into the future for periods where payments are expected to be made. In addition, if for example, the maturity date of the longest dated government stock is 2016, then the appropriate forward rate(s) beyond 2016 will be the 2016 forward rate. If there is a gap in the maturity dates, such that, for example, no government stock matures between 2010 and 2016, then it would be appropriate to estimate the forward rates for the intermediate years by interpolating between the 2010 forward risk free rate and the 2016 forward risk free rate. If the expected future payment is to be taxed as income of the recipient then the risk free rate should not be adjusted for tax.

5.38 The portion of the change in the liability for outstanding claims from the previous reporting date to the current reporting date which is due to discounted

claims not yet settled being one period closer to settlement, ought, conceptually, to be recognised as interest expense of the current reporting period. However, it is considered that the costs of distinguishing this component of the increase in the liability for outstanding claims may exceed the benefits that would be gained from its disclosure. Thus, such increase may be included in claims expense for the current reporting period.

Levies and Charges

STANDARD

5.39 A liability for levies and charges must be recognised on the acceptance of risks that result in the requirement to pay those levies and charges. An expense must be recognised for the levies and charges incurred during the financial year, other than levies and charges that the entity has collected on behalf of others, on the same basis as the recognition of premium revenue.

COMMENTARY

5.40 The levies and charges imposed by government authorities in respect of certain classes of insurance business are expenses of the insurer, as discussed in paragraph 5.3. The amounts of these levies and charges are often calculated as percentages of the insurer's gross written premium for the financial year. A liability for unpaid levies and charges should be recognised by the insurer on the acceptance during the financial year from those insured of risks that result in the requirement to pay the levies and charges to the authorities. This liability should include an estimate for any levies and charges incurred during the financial year which have not been formally assessed by the authorities.

5.41 Those levies and charges that are imposed on the insurer by government authorities represent a cost to the insurer of earning premium revenue. An expense should be recognised for such levies and charges incurred during the financial year on the same basis as the recognition of premium revenue. The portion of the levies and charges incurred that relates to unearned premium therefore should be recognised as a prepayment. The levies and charges expense for the financial year should be disclosed in the financial statements when considered to be useful to users.

Reinsurance Premiums

STANDARD

5.42 Reinsurance contracts must be accounted for as reinsurance in accordance with paragraphs 5.45 and 5.54 when and only when they provide for the transfer of risk against loss or liability from the ceding insurer to the reinsurer.

5.43 When a contract does not, despite its form, provide for the transfer of risk against loss or liability from the ceding insurer to the reinsurer, it must

not be accounted for as reinsurance. The premium paid by the ceding insurer must be recognised as:

(a) an asset by the ceding insurer; and

(b) a liability by the reinsurer.

COMMENTARY

5.44 A contract is not accounted for as reinsurance, regardless of its legal form, unless it provides for the transfer of risk from the ceding insurer to the reinsurer. This means, for example, that the amounts paid and received under a contract which provides for only an immaterial transfer of risk will be recognised as an asset by the ceding insurer and as a liability by the reinsurer. If a contract does not transfer risks from the ceding insurer to the reinsurer, a contract does not give rise to premiums that are revenues and claims that are expenses.

STANDARD

5.45 Premium ceded to reinsurers must be recognised by the direct insurer as outwards reinsurance premium expense in accordance with the pattern of reinsurance service. Retrocessions must be recognised by the ceding reinsurer as expenses in accordance with the pattern of reinsurance service.

COMMENTARY

5.46 It is common for insurers to reinsure a portion of the risks that they accept. To secure reinsurance cover, the insurer passes on a portion of the premiums received from those insured. This is usually done using reinsurance treaties under which the direct (or ceding) insurer typically agrees to pass on to a reinsurer a specified portion of the risks and premiums for a particular type of business that it underwrites over a specified period. This is known as treaty reinsurance. Reinsurance arrangements are also made in relation to individual risks (rather than whole classes of business) on an ad hoc basis. This is typically known as facultative reinsurance.

5.47 Under reinsurance arrangements, the insurer may cede risk and premium to the reinsurer on a proportional basis. Alternatively, the risk and premium may be ceded on a non-proportional basis, such as for excess of loss reinsurance which typically indemnifies the direct insurer against losses above a specified level on a specified range of business.

5.48 The direct insurer should account for direct insurance and reinsurance transactions on a gross basis, so that the extent and effectiveness of the reinsurance arrangements are apparent to the users of the financial report, and an indication of the insurer's risk management performance is provided to users. Thus, the gross amount of premiums earned during the reporting period by the direct insurer should be recognised as revenue because it undertakes to indemnify the full amount of the specified losses of those it has insured, regardless of the reinsurance arrangements. Correspondingly, the direct insurer should recognise the gross

amount of claims expense incurred during the financial year because it is obliged to meet the full cost of successful claims by those it has insured

5.49 Accordingly, premium ceded to reinsurers (outwards reinsurance premium) should be recognised as an expense of the direct insurer on the basis that it is an outgoing incurred in undertaking the business of direct insurance underwriting, and is not to be netted against premium revenue. Reinsurance recoveries received or receivable in respect of the reporting period from a reinsurer should be recognised by the direct insurer as revenue, and are not to be netted against claims expense or outwards reinsurance premium expense.

5.50 Outwards reinsurance premium expense should be recognised in the statement of financial performance in accordance with the pattern of reinsurance service. For proportional reinsurance, this would normally be consistent with the pattern of risk of the underlying direct insurance policies. For non-proportional reinsurance, the expense would normally be recognised over the period of the reinsurance arrangement.

5.51 Frequently, a reinsurer will cede a portion of the risk accepted from a direct insurer to another reinsurer. This is generally referred to as retrocession, with the accepting reinsurer referred to as the retrocessionaire and the premiums ceded in these circumstances referred to as retrocessions.

5.52 Retrocessions should be recognised by the ceding reinsurer in the same way as a direct insurer recognises outwards reinsurance, that is, as an expense, and claims recovered or recoverable from retrocessionaires in respect of the reporting period should be recognised as revenue, for the reasons discussed in paragraphs 5.48 and 5.49.

5.53 Similar treatments for premium accepted and reinsured, and claims and claims recoveries would be required for reinsurers further along the reinsurance chain.

STANDARD

5.54 Inwards reinsurance premium revenue and retrocessions revenue must be recognised by the accepting reinsurer in accordance with the standards set out in paragraphs 5.1, 5.8, 5.12 and 5.15.

COMMENTARY

5.55 From the perspective of the reinsurer, reinsurance premiums accepted are akin to premiums accepted by the direct insurer. The reinsurer should recognise premiums ceded to it (inwards reinsurance) as revenue in the same way as the direct insurer treats the acceptance of original premiums as revenue. Correspondingly, the reinsurer should recognise claims from insurers in the same way as the direct insurer recognises claims from those it has insured, that is, as an expense.

5.56 Premiums accepted by the reinsurer under proportional or non-proportional treaty reinsurance arrangements should be recognised from the attachment date, that is, the date from which the reinsurer bears its proportion of the relevant risks underwritten by the direct insurer. Reinsurers usually use bases of recognition that approximate the dates of bearing the risks. For example, the reinsurer may assume that its acceptance of risks occurs from the middle of the period for which the aggregate ceded premiums are advised by the direct insurer. This approach is acceptable provided that the premiums received or receivable in respect of the reporting period are recognised in that period, whether or not the periodic advice from the direct insurer has been received.

5.57 The periodic advices from each direct insurer also include aggregate information relating to the liability for outstanding claims. The reinsurer should measure its liability for outstanding claims on the basis of this information and its past experience of the claims payments made under reinsurance arrangements. As the factors used by the direct insurers in calculating the advised outstanding claims may vary considerably, reinsurers are not required to include proportional treaty reinsurance business in the disclosures of average inflation and discount rates, and average weighted expected term to settlement (refer to paragraph 6.6).

Portfolio Transfers

STANDARD

5.58 Where the responsibility in relation to claims on transferred insurance business remains with the transferring insurer, the transfer must be accounted for by the transferring insurer and the accepting insurer as reinsurance business.

COMMENTARY

5.59 Portfolio transfer is a term used to describe the process by which premiums and claims are transferred from one insurer to another. Transfers may be completed in a number of ways in relation to claims arising from events that occurred before the transfer. The receiving insurer may take responsibility in relation to all claims under the agreement or treaty that have not yet been paid, or it may take responsibility only in relation to those claims arising from events that occur after the date of transfer.

5.60 In relation to the transfer of direct insurance business, although the acquiring insurer agrees to meet the claims of those insured from a particular time, the contractual responsibility of the original direct insurer to meet those claims normally remains. However, in relation to the withdrawal of a reinsurer from a reinsurance treaty arrangement, the contractual responsibility of the reinsurer to the direct insurer in relation to outstanding claims may be passed back to the direct insurer with a return of unearned premium, or may be retained by the withdrawing reinsurer. In the former case, the direct insurer may choose to reinsure the

outstanding claims with another reinsurer. This assuming reinsurer would be ceded premium for bearing liability in relation to existing outstanding claims.

5.61 Where the responsibility in relation to claims on transferred insurance business remains with the transferring insurer:

(a) the transferring insurer should recognise the transferred premium revenue and the relevant outstanding claims in the same way as other outwards reinsurance business; and

(b) the accepting insurer should recognise the premium revenue ceded to it and the relevant outstanding claims in the same way as other inwards reinsurance business.

STANDARD

5.62 Where the responsibility in relation to claims on transferred insurance business passes from the transferring insurer to the accepting insurer, the transfer must be accounted for as a portfolio withdrawal by the transferring insurer and as a portfolio assumption by the accepting insurer.

5.63 A portfolio withdrawal must be accounted for by the transferring insurer by eliminating the liabilities and assets connected with the risks transferred. A portfolio assumption must be accounted for by the accepting insurer by recognising the relevant amount of unearned premium revenue and the outstanding claims for which the transferring insurer is no longer responsible.

Underwriting Pools and Coinsurance

STANDARD

5.64 Insurance business allocated through underwriting pools and coinsurance arrangements by an entity acting as agent must be accounted for by the accepting insurer as direct insurance business.

COMMENTARY

5.65 Direct insurers or reinsurers may form underwriting pools or enter coinsurance arrangements as vehicles for jointly insuring particular risks or types of risks. Premiums, claims and other expenses are usually shared in agreed ratios by insurers involved in these arrangements.

5.66 Many underwriting pools and coinsurance arrangements involve the acceptance of risks by an entity acting as an agent for pool members or coinsurers. The entity receives premiums and pays claims and expenses, and allocates shares of the business to each pool member or coinsurer in agreed ratios. As the entity acting as agent is effectively not an insurer, the business allocated to pool members and coinsurers is not reinsurance business. Pool members and coinsurers should treat such business allocated to them as direct insurance business.

STANDARD

5.67 Business directly underwritten by a member of an underwriting pool or coinsurance arrangement must be accounted for as direct insurance business and the portion of the risk reinsured by other pool members or coinsurers, determined by reference to the extent of the shares in the pool or arrangement of other pool members or coinsurers, must be accounted for as outwards reinsurance. The pool member's or coinsurer's share of insurance business that other insurers place in the pool or arrangement must be accounted for as inwards reinsurance.

COMMENTARY

5.68 Some underwriting pools and coinsurance arrangements involve members of the pool or coinsurers directly underwriting risks and then passing all of those risks into the pool or arrangement. These risks are then shared among pool members or coinsurers. For this type of underwriting pool or arrangement, this Standard requires an insurer to treat its share of the business that other insurers place with the pool or arrangement as inwards reinsurance, and the business that it writes and passes into the pool or arrangement as direct insurance business which it reinsures to the extent of the shares in the pool or arrangement of the other pool members or coinsurers. This approach results in the insurer's financial report properly reflecting its obligations to those it has directly insured and the substance of the transactions with the pool members or coinsurers.

Assets — Investments

STANDARD

5.69 Investments integral to the entity's insurance activities must be measured at net market values as at the reporting date. Any changes in the net market values must be recognised in the statement of financial performance as revenues or expenses in the reporting period in which the changes occur. For investments without active and liquid markets, the methods used to determine their net market values must be disclosed.

COMMENTARY

5.70 Where the primary activity of an entity is the provision of insurance, all investments of that entity should be regarded as integral to its insurance activities.

5.71 Investments are primarily held as a means of generating revenues. Operating assets are those assets used in the day-to-day operations of the business, some of which may also directly generate revenues for the insurer. Accounts receivable would include premiums, reinsurance recoveries and other recoveries owed at the reporting date by those insured, agents, brokers or reinsurers. The recognition of acquisition costs as assets is discussed below at paragraphs 5.79 to 5.82.

5.72 An insurer's ability to pay claims and to continue to offer insurance cover to

its clients normally depends on the extent of its investments and on its investment performance. The use of net market value as the basis for measuring investments integral to the entity's insurance activities enables users of the financial report of an insurer to assess more accurately the insurer's past performance and future investment cash flows, and thus its ability to remain in business.

5.73 In determining net market values of investments, reference is made to the market that provides the most reliable information, which is likely to be the market in which the investment is normally traded. In addition, while investments are often managed in the context of portfolios, they are nonetheless measured individually.

5.74 For many assets, such as equity securities of major listed companies, quoted market prices provide a reliable measure of net market value at reporting date. However, in some cases, it may be difficult to reliably measure the net market value of an asset. For example, in the case of a shareholding in an unlisted company there may not be an active and liquid market for the shares. In such circumstances, the insurer would make its best estimate of the net market value of that asset, taking into account all available information. In the case of material classes of investments, disclosure of the methods used in determining the net market values are relevant to users of the financial statements in assessing the financial performance and financial position of the insurer.

5.75 Using a net market value basis means that revenues from investments integral to the entity's insurance activities would include:

(a) unrealised amounts relating to the changes during the reporting period in net market values of investments held as at the reporting date; and

(b) in respect of investments realised during the reporting period, the difference between the carrying amounts of the investments as at the beginning of the reporting period (or when acquired, if acquired after the beginning of the reporting period) and the net market value when realised (that is, the net disposal proceeds); and

(c) amounts such as interest, dividends from post-acquisition profits and property rentals.

5.76 Where land and buildings are investments integral to the entity's insurance activities, the valuation of land and buildings is to be undertaken by an independent valuer, or where an insurer has in its employ a qualified valuer, by an internal valuer, so long as the basis of valuation has been subject to review by an independent valuer. Both independent and internal valuers are to hold a recognised professional qualification and have experience in the location and category of asset being valued.

Assets — Other Assets

STANDARD

5.77 Assets other than investments integral to the entity's insurance activities must be measured in accordance with generally accepted accounting practice.

COMMENTARY

5.78 In relation to operating assets, accounts receivable and deferred acquisition costs, the historical cost basis of measurement is considered to be appropriate. Insurers do not normally rely on increments in the net market values of these assets to meet their outstanding claims, and the changes in the net market values of such assets are not generally of significance in assessing the performance of an insurer.

Assets — Acquisition Costs

STANDARD

5.79 Acquisition costs incurred in obtaining and recording policies of insurance must be recognised as assets where they can be reliably measured and it is probable that they will give rise to premium revenue that will be recognised in subsequent reporting periods.

COMMENTARY

5.80 Acquisition costs are incurred in obtaining and recording policies of insurance. They include commission or brokerage paid to agents or brokers for obtaining business for the insurer, selling and underwriting costs such as advertising and risk assessment, the administrative costs of recording policy information and premium collection costs.

5.81 Because such costs are usually incurred at acquisition whilst the pattern of earnings occurs throughout the policy periods, which may extend beyond the reporting date, those acquisition costs which lead to the obtaining of future benefits for the insurer should be recognised as assets. The amount of acquisition costs recognised as assets should be amortised over the reporting periods expected to benefit from the expenditure in accordance with the standards set out in paragraph 5.83

5.82 For an asset to be recognised, it shall be probable that the future economic benefits will eventuate, and that it possesses a cost or other value that can be measured reliably. Direct acquisition costs such as commission or brokerage are readily measurable. However, it may be difficult to reliably measure indirect costs which give rise to premium revenue, such as administration costs, because it is difficult to associate them with particular policies of insurance.

Assets — Amortisation of Acquisition Costs

STANDARD

5.83 Deferred acquisition costs must be amortised systematically over the reporting periods expected to benefit from the acquisition costs incurred, being the terms of the related policies. When the recoverable amount of deferred acquisition costs is below cost, that is, when the sum of the deferred acquisition costs and the present value of both expected future claims and settlement costs, in relation to business written to the reporting date, exceeds related unearned premiums (premium deficiency) the deferred acquisition costs must be written down to recoverable amount and the write-down must be recognised as an expense.

COMMENTARY

5.84 The carrying amount of deferred acquisition costs should be written down to recoverable amount where this is less than the deferred costs, based on an assessment of the aggregate portfolio of insurance business written by the insurer to the reporting date.

Assets — Recoveries Receivable

STANDARD

5.85 Claims recoveries receivable from reinsurers and other recoveries receivable must be recognised as assets where the amount to be recovered can be reliably measured. Recoveries receivable must be measured as the present value of the expected future receipts.

COMMENTARY

5.86 Reinsurance and other recoveries receivable satisfy the definition of assets and are usually quantifiable under the terms of reinsurance or direct insurance arrangements. The probability of receiving the recoveries should be assessed in the light of prevailing circumstances, including the ability of the debtor to meet its obligations.

5.87 Consistent with the approach set out in paragraphs 5.48 and 5.49, this Standard requires recoveries receivable to be recognised as an asset and not offset against the liability for outstanding claims, subject to any right of set-off as defined in FRS-27: *Right of Set-off*. There is no right of set-off of claims due to those insured and recoveries receivable from reinsurers.

5.88 For some classes of insurance business, recoveries receivable may not be received for a considerable time. In these circumstances, recoveries receivable should be inflated and discounted in the same manner as for the liability for outstanding claims. The same factors considered in measuring the liability for outstanding claims are relevant in determining the appropriate carrying amount of recoveries receivable. Recoveries receivable may be measured as the amount of

the expected future receipts, provided that the amount of the expected future receipt does not differ materially from the present value of those receipts.

5.89 Consistent with the treatment of reinsurance by the direct insurer, claims to be recovered by a reinsurer from retrocessionaires should be recognised as an asset where they meet the criteria set out in paragraph 5.85 and not offset against the reinsurer's liability for outstanding claims, which should be based on the amounts due to other insurers.

Imputed Inflows and Outflows

STANDARD

5.90 An insurer must recognise imputed inflows and outflows as revenues and expenses, when and only when, such imputed flows relate to transactions with external entities.

COMMENTARY

5.91 In cases where there are no transactions with external entities, such as with owner-occupied buildings, the insurer is dealing with itself. There is no transaction or other past event that gives rise to a revenue or an expense. Any inflows and outflows imputed for internal management purposes would be eliminated in preparing external financial statements.

6 DISCLOSURES

STANDARD

6.1 In relation to the statement of financial position, the financial report must disclose the following items, classified into current and non-current categories, or in the broad order of their liquidity:

(a) investments integral to the entity's insurance activities, by class of investment;

(b) operating assets by class of asset;

(c) deferred acquisition costs;

(d) reinsurance and other recoveries receivable;

(e) liability for outstanding claims; and

(f) premiums received in advance.

6.2 In relation to the statement of financial performance, the financial report must disclose:

(a) the following items of revenue or expense included in the determination of the surplus/deficit before tax for the reporting period:

- **(i) premium revenue;**
- **(ii) inwards reinsurance premium revenue (including retrocessions);**
- **(iii) reinsurance and other recoveries revenue;**

(iv) investment revenue or expense from investments integral to the entity's insurance activities, and its individual components;

(v) direct claims expense;

(vi) reinsurance claims expense;

(vii) outwards reinsurance premium expense (including retrocessions); and

(viii) acquisition costs expense.

(b) the amount by which deferred acquisition costs have been written down during the reporting period to recoverable amount due to the insurer experiencing an unprofitable aggregate portfolio of insurance business, and the circumstances surrounding that unprofitable business; and

(c) the underwriting result for the reporting period, determined as the amount obtained by deducting the sum of claims expense, outwards reinsurance premium expense and underwriting expenses from the sum of direct and inwards reinsurance premium revenues and recoveries revenue.

COMMENTARY

6.3 This Standard requires the underwriting result for the reporting period to be disclosed. This disclosure gives an indication of an insurer's underwriting performance, including the extent to which underwriting activities rely on investment revenues for the payment of claims.

STANDARD

6.4 Where as a result of a premium deficiency, deferred acquisition costs have been written down to zero (in accordance with paragraph 5.83) and a premium deficiency still exists the amount of that deficiency must be disclosed in the notes to the financial statements.

6.5 Outwards reinsurance premium expense must be disclosed separately as a deduction from total premium revenue, and reinsurance and other recoveries revenue must be disclosed separately as a deduction from total claims expense.

6.6 In relation to the liability for outstanding claims, the financial report must disclose:

(a) the undiscounted amount of claims, reconciled to the liability for outstanding claims;

(b) average inflation and discount rate(s) applied for the following periods in measuring claims:

(i) the succeeding year; and

(ii) later than one year from the reporting date; and

(c) the average weighted expected term to settlement from the reporting date of the claims included in the liability for outstanding claims;

except that reinsurers may exclude proportional treaty reinsurance business from the disclosures required by paragraphs 6.6(b) and (c).

STANDARD

6.7 Subject to paragraph 6.9, net claims incurred must be disclosed, showing separately the amount relating to risks borne in the current reporting period and the amount relating to a reassessment of risks borne in all previous reporting periods (claims development). For each of net claims incurred in the current reporting period and the aggregate of net claims incurred in previous reporting periods, the following components must be separately disclosed:

(a) gross claims incurred — undiscounted;

(b) reinsurance and other recoveries — undiscounted; and

(c) discount movements shown separately for parts (a) and (b).

6.8 Subject to paragraph 6.9, an explanation must be provided where net claims incurred relating to a reassessment of risks borne in previous reporting periods are material.

6.9 Paragraphs 6.7 and 6.8 need not be complied with for inwards reinsurance business.

COMMENTARY

6.10 The information provided by a direct insurer to a reinsurer may be insufficient to allow the reinsurer to make the claims development disclosures required by paragraph 6.7. On this basis, for inwards reinsurance business, the Standard allows an exemption from the claims development disclosure requirements.

STANDARD

6.11 Segment information must be disclosed in the financial report in accordance with SSAP-23: Financial Reporting for Segments, with the exception that geographical segments must be determined on the basis of the location of risks insured.

6.12 Accident insurance, in terms of the Accident Insurance Act 1998, must be considered a separate industry segment for the purposes of SSAP-23.

COMMENTARY

6.13 Insurers are required by SSAP-23 to provide particular information on industry and geographical segments. The geographical segments are required by this Standard to be determined on the basis of the location of the risks insured, rather than the location where the business is written. However, New Zealand can be considered a single geographical segment for the purposes of this Standard.

6.14 Accident insurance is insurance business entered into by an insurer under the terms and conditions required by the Accident Insurance Act 1998.

STANDARD

6.15 The credit rating of the insurer must be disclosed. If the insurer is not required to have a credit rating this must be disclosed.

6.16 The insurer must disclose by way of descriptive note the principles on which the insurer's reinsurance programme is structured.

6.17 The amount of equity retained for the purpose of financial soundness and the basis of establishing that amount must be disclosed. A group must make this disclosure for each insurer in the group.

COMMENTARY

6.18 The disclosures on reinsurance and the amount of equity retained by an insurer should describe how the insurer manages its unexpected risks – those risks arising from claims volatility or catastrophe. The disclosures should include the insurer's assessment of the likelihood of claims volatility or catastrophe for particular classes of business and the geographical distribution of its risks as it is these assessments that determine the total level of unexpected risk and therefore the best way of managing that risk.

6.19 Disclosures on reinsurance and the amount of equity retained by an insurer to maintain its continuing financial soundness should describe the types of risks that are covered by these measures and the level of coverage compared to the insurer's total exposure to that type of risk. If the insurer uses other methods to manage its unexpected risks this additional information should also form part of these disclosures. These other methods could include self reinsurance through a parent company, reinsurance through its own asset base, or credit lines that the insurer can draw upon if required. These disclosures in total (reinsurance, equity retention and additional information) should give the user of the financial statements a general understanding of the insurer's principles and methods for managing unexpected risks rather than a detailed explanation.

Actuarial Information

STANDARD

6.20 Where an actuarial report has been obtained, the following must be disclosed in the notes to the financial statements:

(a) if other than the reporting date, the effective date of the calculation or assessment in the actuarial report;

(b) the name and qualifications of the actuary;

(c) **whether the amount of the outstanding claims liability has been determined in accordance with the standards of the New Zealand Society of Actuaries;**

(d) **whether the actuary is satisfied as to the nature, sufficiency and accuracy of the data used to determine the outstanding claims liability;**

(e) **the key assumptions used by the actuary in determining the outstanding claims liability; and**

(f) **any qualifications contained in the actuarial report.**

Other Disclosures

COMMENTARY

6.21 This Standard prescribes disclosure requirements specific to insurance activities. Other financial reporting standards prescribe disclosure requirements for all entities, including those that carry on insurance activities.

7 COMPARATIVE INFORMATION

STANDARD

7.1 In the first reporting period to which this Standard applies, comparative figures for the prior period must be reclassified, where necessary, so that such information corresponds to the classification presented for the current period, unless this is impracticable. Where there has been a reclassification of prior year amounts, the nature of, and the reason for, the reclassification must be disclosed.

8 TRANSITIONAL PROVISIONS

STANDARD

8.1 Any revenue or expense adjustment made by an entity in complying with the requirements of this Standard for the first time, must be recognised in the statement of movements in equity as an adjustment against equity at the beginning of the period in which the adjustment is made.

8.2 Any asset revaluation reserve for investments integral to the entity's insurance business recognised in the financial statements of an entity prior to the application of this Standard must be reclassified within equity. The amount reclassified must not be taken to the statement of financial performance nor recognised in the statement of movements in equity.

APPENDIX

Comparison of FRS-35 with International and Australian Accounting Standards

This comparison appendix was prepared as at 30 June 1999 and deals only with significant differences in the standards, is produced for information purposes only and does not form part of the standards in FRS-35.

The International Accounting Standards Committee has promulgated no International Accounting Standard on this topic.

The Australian financial reporting standard comparable to FRS-35 is AASB-1023 (revised 1996), *Financial Reporting of General Insurance Business*. There is substantial agreement between AASB-1023 and FRS-35. The following summarises the significant differences.

Scope

AASB-1023 excludes medical benefits insurance; there is no such exclusion from FRS-35.

AASB-1023 excludes all life insurance; FRS-35 excludes only life insurance as defined in FRS-34: *Life Insurance Business*.

Discount Rate

FRS-35 requires the discount rate(s) to be used in measuring the present value of the expected future payments, to be the risk free rate(s) appropriate to the future period or periods over which the payments are expected to be made. AASB 1023 requires that the discount rate or rates must be the rate or rates of return that the insurer anticipates it could earn if sufficient funds were available to meet claims liabilities as they fall due.

Valuation of land and buildings

FRS-35 requires that where land and buildings are assets integral to the entity's insurance activities, their valuation is to be undertaken by an independent valuer, or where an insurer has in its employ a qualified valuer, by an internal valuer, so long as the basis of valuation has been subject to review by an independent valuer. Both valuers are to hold a recognised professional qualification and have experience in the location and category of asset being valued. AASB-1023 requires all land and buildings to be recognised as assets integral to the entity's insurance activities but has no specific requirement for the involvement of independent or qualified valuers.

Segmental reporting

FRS-35 requires that accident insurance activities be regarded as an industry segment for the purposes of reporting segments under SSAP-23: *Financial Reporting for Segments*. AASB-1023 does not specify any particular industry segments.

HISTORY

No previously issued accounting standards are superseded by this Financial Reporting Standard.

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