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INDUSTRY ACCOUNTING GUIDELINE 1
ACCOUNTING FOR GENERAL INSURANCE BUSINESS

(Issued June 1993; revised July 2000 and December 2001)

This Guideline sets out recommendations, intended to represent best practice, on the accounting for general insurance business.

The provisions of this Guideline should be read in conjunction with the Foreword to Statements of Standard Accounting Practice, Interpretations and Accounting Guidelines and need not be applied to immaterial items.

Part 1 - Introduction

Objective

1. The main aim in issuing this Guideline is to narrow areas of difference and variation in accounting treatment used in the preparation of the various financial statements and other financial information under the Companies Ordinance and Insurance Companies Ordinance ("Ordinance") and to enhance the usefulness of publicly available financial information of general insurers.

2. This Guideline sets out the recommended accounting for general insurance business, including reinsurance. Because of the nature of general insurance business, the period of insurance cover usually extends into different accounting periods. Therefore, the primary issue in accounting for general insurance policies is the recognition of revenue and associated costs (including claims) in the period in which the risk arises. This Guideline does not apply to long term business since it is subject to very different considerations.

3. This Guideline does not provide specific rules on accounting for investments as these can be found in SSAP 24 "Accounting for investments in securities" although some guidance is provided in Appendix 1 on the application of SSAP 24 to the investments of general insurers.

4. This Guideline applies the recognition criteria established in the "Framework for the preparation and presentation of financial statements" to determine when policy revenue and costs associated with general insurance business would be recognised. It also provides practical guidance on the application of these criteria.

Scope

5. The business of insurance can be split broadly into two main types: general insurance business and long term insurance business. The Guideline deals only with general insurance including reinsurance.

6. The recommendations contained in this Guideline are intended to be applicable to all persons (companies or individuals) carrying on general insurance business in or from Hong Kong, including reinsurers.

7. A person shall be deemed to carry on insurance business in or from Hong Kong if he opens or maintains an office or agency in Hong Kong for the purpose of carrying on insurance business, or he holds himself out as carrying on insurance business, in or from Hong Kong. Insurers will fall within this scope if they are incorporated in Hong Kong, have a place of business here, are represented here by an agent or are holding themselves out as carrying on insurance business in or from Hong Kong. Such persons are required to be authorized under the Ordinance and would include:

   a. a Hong Kong incorporated company carrying on insurance business in Hong Kong;

   b. a Hong Kong incorporated company carrying on insurance business through an overseas branch or agency, whether or not it is operating as an insurer in Hong Kong;

   c. an overseas incorporated company carrying on insurance business through a Hong Kong branch;

   d. an overseas company carrying on insurance business in Hong Kong by means of an agency;

   e. a captive insurer, as defined in section 2(7) of the Ordinance;

   f. reinsurance companies carrying on reinsurance business in or from Hong Kong (but see paragraph 11); and

   g. any other person holding himself out as carrying on insurance business in or from Hong Kong.

8. General insurance contracts provide indemnity for a specified period against specified losses resulting from the occurrence of specified types of events. This includes all types of insurance business other than long term insurance business. General insurance business is defined in Part 3 of the First Schedule to the Ordinance as falling into seventeen different classes.

9. The location of the risks is not relevant in determining whether a particular entity falls within the scope of the Ordinance. Thus, for example, an insurer or a reinsurer who is incorporated overseas and who has not established a place of business in Hong Kong, is not represented by an agent in Hong Kong, and does not hold himself out as carrying on insurance business in or from Hong Kong, can accept insurance or reinsurance premiums relating to Hong Kong risks, without having to be authorized under the Ordinance.

10. The following persons, although involved in insurance business, do not have to be authorized under the Ordinance:

   a. a Hong Kong incorporated company with an overseas incorporated subsidiary that carries on insurance business outside Hong Kong, provided that the Hong Kong holding company is not itself an insurer;

   b. an insurance agent (being a person who holds himself out to advise on or arrange contracts of insurance in or from Hong Kong as an agent or subagent of one or more insurers). However, an insurer is required to register its appointed insurance agents in accordance with section 66 of the Ordinance and the Insurance Authority has the power, also under section 66, to direct the insurer to de-register its appointed insurance agents under certain conditions.

11. Section 51 of the Ordinance specifically exempts the following persons from the provisions of the Ordinance:

    a. any body of persons carrying on insurance business in Hong Kong whose gross premiums do not exceed HK$500,000 in any financial year and who are bound together for certain specified purposes but not for the purpose of gain;

    b. persons carrying on in Hong Kong reinsurance business only (unless incorporated in Hong Kong or, if incorporated elsewhere, who have a place of business in Hong Kong or are represented in Hong Kong by an agent or any other person or partnership having a place of business in Hong Kong);

    c. registered trade unions (subject to certain limitations);

    d. registered co-operative societies;

    e. the Hong Kong Export Credit Insurance Corporation;

    f. banks, restricted licence banks and deposit-taking companies carrying on insurance business, limited to certain long term or general insurance business carried on solely for the purposes of their banking or deposit-taking business;

    g. the Credit Union League of Hong Kong;

    h. a recognized clearing house (as defined in section 51(h) of the Ordinance).

12. Under section 53 of the Ordinance the Chief Executive in Council has power to exempt any insurer from any of the provisions of the Ordinance or to modify or vary any of its provisions in respect of any insurer.

Reporting framework

13. The legal framework for financial reporting for insurers in Hong Kong is derived from the Companies Ordinance and the Ordinance as follows:

Companies Ordinance

14. Section 123(1) of the Companies Ordinance requires that the balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and the profit and loss account shall give a true and fair view of the profit or loss of the company for the financial year. Section 126(1) of the Companies Ordinance imposes the same requirement in relation to the company and subsidiaries included in group accounts so far as members of the company are concerned.

15. Such financial statements which are required to give a true and fair view are required to adopt Statements of Standard Accounting Practice and have regard to Accounting Guidelines issued by the Hong Kong Society of Accountants.

16. If an insurer is operating in Hong Kong through a branch, there are no financial reporting requirements under the Companies Ordinance.

The Ordinance

17. The Ordinance and the related regulations, inter alia, provide the legal framework for regulatory returns to the Insurance Authority. The following regulatory returns are required under the Ordinance:

    a. financial information which has been prepared in accordance with Parts 4 and 5 of the Third Schedule in respect of the total business of the insurer;

    b. forms which have been prepared under Part 8 of the Third Schedule in respect of the Hong Kong business of the insurer; and

    c. a statement which has been prepared under Part 9 of the Third Schedule in respect of the Hong Kong business of the insurer.

18. In preparing the above regulatory returns insurers are required to apply the Insurance Companies (General Business)(Valuation) Regulation ("Valuation Regulation") in determining the carrying value of the assets and liabilities. The Valuation Regulation aims at providing a standard and prudent valuation basis for the assets and liabilities of an insurer and ensuring a prudent spread of its investments for solvency purposes. This Guideline sets out the accounting treatment of assets and liabilities prior to any adjustments required by the Valuation Regulation, although in this Guideline reference has been made to the requirements of the Valuation Regulation where appropriate.

19. Insurers are permitted to apply for an accounting concession under section 17(2) of the Ordinance to vary the requirement to prepare the financial information required under Parts 4 and 5 of the Third Schedule. In granting this concession to insurers which are not incorporated in Hong Kong, the Insurance Authority will request that certain financial information be submitted in respect of the business written by the insurer's operations located in Hong Kong (the "Branch"). The financial information that is required to be submitted by the Branch (the "Branch Accounts") is required to give a true and fair view of the state of affairs of the Branch as at the end of the accounting period and the profit or loss for the accounting period. In preparing the Branch Accounts it is not required that they comply with the disclosure and valuation requirements of the Ordinance. This Guideline applies to the preparation of such Branch Accounts, except to the extent that it does not conflict with guidance provided by the Insurance Authority.

20. This Guideline provides recommendations on the presentation and the general layout of financial statements of a general insurer, but only as a supplement to the applicable requirements set out in Statements of Standard Accounting Practice, the Companies Ordinance and the Ordinance. In particular there are special considerations which need to be addressed in the preparation of the forms and statement under Parts 8 and 9, and additional guidance is included in Appendix 1.

Part 2 - Definitions

21. The following terms are used in this Guideline with the meanings specified:

a. *Acquisition costs*

All costs which vary with, and are primarily related to, the acquisition of new insurance contracts and the renewal of existing insurance contracts. This includes direct costs such as commissions and brokerage, and indirect costs such as salary costs for underwriting staff and processing costs. Refer to Appendix 2 for further examples of acquisition costs.

b. *Annual accounting basis*

The annual accounting basis is where the underwriting result disclosed in the financial statements comprises the result for the current accounting period and any adjustments during the current accounting period to estimates made in prior accounting periods.

c. *Assuming company or reinsurer*

See "Reinsurance".

d. *Ceding company or cedent or reinsured*

See "Reinsurance".

e. *Claim*

The amount payable under a contract of insurance arising from the occurrence of an insured event.

f. *Claims handling expenses*

Expenses incurred by an insurer which are attributable to the negotiation and settlement of claims whether the expenses are incurred internally or externally. Internal expenses include all direct expenses of the claims department and any other general administration expenses attributable to the handling of claims.

g. *Claims incurred*

A claim is incurred when the event giving rise to the claim takes place. The amount shown in the financial statements for claims incurred include paid claims and the movement in claims outstanding, including claims handling expenses.

h. *Claims incurred but not reported (IBNR)*

Claims arising out of events which have occurred by the balance sheet date but have not been reported to the insurer by that date.

i. *Claims outstanding*

The amount provided to cover the estimated ultimate cost in settling claims arising out of events which have occurred by the balance sheet date, including claims incurred but not reported and claims handling expenses, less amounts already paid in respect of those claims.

j. *Co-insurance*

An arrangement whereby two or more insurers enter into a single contract with the insured to cover a risk in agreed proportions at a specified premium.

k. *Deferred acquisition costs*

Acquisition costs relating to business in force at the balance sheet date which are carried forward from one accounting period to subsequent accounting periods.

l. *Deferred annual basis*

A method of accounting for general insurance business where all items of revenue and expense relating to general insurance business are accounted for one accounting period in arrears. (This is not the recommended practice.)

m. *Direct business*

All business where the insurer has a direct contractual relationship with the insured who is not itself an insurer (including co-insurance business but excluding reinsurance business).

n. *Discounting*

The calculation of a present value at a given date of a future cash flow transaction.

o. *Earned premiums*

The portion of written premiums (including where relevant those of prior accounting periods) attributable to the risks borne by the insurer during the accounting period.

p. *Facultative reinsurance*

See "Reinsurance ".

q. *Financing arrangements*

Financing arrangements are those contractual arrangements which do not involve a significant transfer or acceptance of insurance risk or claims development risk (e.g. the maximum obligations of the "reinsurer" are limited to an agreed amount, often linked to the premium paid plus any interest thereon).

r. *Fund accounting basis*

A method of accounting whereby, for each underwriting year, an account is maintained in which premiums on policies incepted during that underwriting year are recorded, together with claims payments under those policies, irrespective of the accounting year in which the claims occurred, and other relevant income and outgoings. A result is not drawn until sufficient time has passed for a result to be determined with reasonable certainty, usually not exceeding three years. Also known as underwriting year accounting basis.

s. *General insurance business*

Insurance (including reinsurance) business falling within one of the classes of insurance defined in Part 3 of the First Schedule to the Ordinance.

t. *Inception of risk*

The time at which the period of cover commences under a policy or contract of insurance. For this purpose, a policy or contract providing continuing open cover is deemed to commence on each anniversary date of the contract.

u. *Indirect business*

Reinsurance inwards business.

v. *Long tail business*

Insurance business where the ultimate cost of claims is not known until a significant period after the event giving rise to the claims.

w. *Maintenance costs*

Expenses which may vary with the level of acquisition and renewal of business but which are distinguished from acquisition costs by the fact that they are incurred to service such business after it has been acquired or renewed. Refer to Appendix 2 for examples of such costs.

x. *Non-proportional reinsurance*

Contracts of reinsurance where, in return for a premium, the reinsurer accepts either the whole or part of the liability for losses or claims incurred by the ceding company in excess of an agreed claim amount, normally subject to an upper limit.

y. *Pipeline premiums*

This has the same meaning as "unclosed business".

z. *Portfolio claim payment*

Amount payable by one insurer to another in consideration for a contract whereby the latter insurer agrees to assume responsibility for the unpaid claims incurred by the former insurer prior to a date specified in the contract.

aa. *Portfolio premium payment*

Amount payable by one insurer to another in consideration for a contract whereby the latter agrees to assume responsibility for the claims arising on a portfolio of in-force business written by the former from a future date until the expiry of the policies.

ab. *Premium deficiency*

The excess of the estimated value of claims and related expenses likely to arise after the balance sheet date from contracts concluded before that date over and above unearned premiums (net of deferred acquisition costs) relating to those contracts.

ac. *Proportional reinsurance*

A contract of reinsurance where in return for a proportion of the original premium the reinsurer accepts liability for the same proportion of each related claim against the cedent.

ad. *Reinsurance*

An arrangement where one party (the reinsurer or assuming company), in consideration for a premium, agrees to indemnify another party (the cedent or reinsured) against part or all of the liability assumed by the cedent under a policy or policies of insurance. Reinsurance may be on the basis of individual risks (facultative) or groups of risks (treaty).

ae. *Reinsurance inwards*

The acceptance of risks under a contract of reinsurance.

af. *Reinsurance outwards*

The placing of risks under a contract of reinsurance.

ag. *Retrocession*

The reinsurance outwards of risks previously accepted by an insurer as reinsurance inwards. The recipient is known as the retrocessionaire. In this Guideline references to reinsurance include retrocession.

ah. *Run-off deviation*

The difference between the claims provision made at the beginning of an accounting period for claims outstanding incurred in previous accounting periods, and the payments made during the accounting period on account of claims incurred in previous accounting periods and the claims provision at the end of the accounting period for such claims outstanding.

ai. *Short-tail business*

Insurance business where the ultimate cost of claims is known before, or soon after, the event giving rise to the claim occurred (for example, fire and motor own damage).

aj. *Technical provisions*

Provisions held to meet underwriting liabilities. The term covers unearned premium, premium deficiency provision and claims outstanding provision (both notified and incurred but not reported).

ak. *Treaty reinsurance*

See "Reinsurance".

al. *Unclosed business*

Premiums in respect of risks underwritten and incepted prior to the balance sheet date for which closing information has not been confirmed and/or which are not processed through the accounting system until a subsequent accounting period.

am. *Underwriting year*

The accounting period in which the contract of insurance incepted.

an. *Unearned premiums*

The portion of written premiums relating to the period of risk after the balance sheet date which is deferred to subsequent accounting periods.

ao. *Unexpired risks provision*

Total amount of likely claims arising from the period of risk after the balance sheet date on contracts concluded before that date. This will amount to the addition of unearned premium and premium deficiency provisions as defined above.

ap. *Written premiums*

Premiums which an insurer is contractually entitled to receive from the insured in respect of contracts of insurance entered into during the accounting period and adjustments arising in the accounting period to premiums receivable in respect of contracts entered into in prior accounting periods. For some treaty reinsurance inwards business, information on the risk inception dates may not be available to the accepting reinsurer. In such circumstances, written premiums are defined as those premiums advised to the reinsurer during the accounting period.

Under the fund accounting basis the premiums written are those in respect of contracts incepting in the underwriting year in question.

Part 3 - Recommended practice

Accounting basis

22. The annual accounting basis would be used unless an underwriting result cannot reasonably be determined at the end of the accounting year without an unacceptably high level of estimation. Only in such circumstances, can the fund accounting basis be used.

23. The fund accounting basis is normally only used for marine hull, aviation and transport business and some non-proportional reinsurance business in respect of which long reporting delays can often be expected.

24. The choice of the appropriate accounting basis to be used by an insurer will depend on the nature of the insurance business written by the insurer and the extent to which reasonable estimates can be made to determine the underwriting result at the end of the accounting period. For most lines of business, reasonable estimates can be made and therefore the annual accounting basis will be the appropriate method to use.

Premiums

25. Written premium would be recognised from the date the insurer has contracted to accept the risk and the amount of premium can be measured reliably.

26. Where the insurer has accepted a risk but the premium has not been processed as at an accounting date, a reasonable estimate of such unclosed business would be made based on subsequent development (or, where this is not available, based on previous experience), and recognised on the same basis as other premium revenue

27. For inward treaty reinsurance business where details by policy are not available to the reinsurer, the reinsurer would recognise premium revenue from a date which is assumed to be the average date on which the various risks accepted under the treaty incept. In theory, unclosed business under a treaty reinsurance inwards arrangement would be accounted for on the same basis as for other unclosed business discussed in paragraph 26. In practice, the information regarding risks assumed up to an accounting date may not be received from the ceding insurer in time to be included in the reinsurer's accounting records as at that particular accounting date. Where such delays are regular and recurring, an earlier cut-off date for treaty reinsurance inwards is acceptable. In such circumstances, the early cut-off date would be maintained from one accounting period to the next so that a full period of treaty results is included in each accounting period.

28. For business where the premium written is subject to adjustment, the actual adjusted premium would be used as the basis of recognising premium revenue. Where the actual adjusted premium is not known at the time of preparation of the financial statements, the adjusted premium would be based on any other relevant information that is available. The following principles apply:

    a. reductions to premium would be recognised as soon as they can be foreseen; and

    b. additions to premium would only be recorded when the increases are known or can be estimated with reasonable certainty.

29. When an insurer uses the "pre-debit" method of accounting for renewals (i.e. where renewal premiums are recognised as revenue when the renewal notice is issued), an estimate of lapses would be made at the year end based on subsequent development or, where this is not available, based on previous experience of non-renewals.

30. Few written premiums will be for a period of risk which coincides with the accounting period of the insurer. Under the annual accounting basis, and in accordance with the accrual basis of accounting in SSAP 1 "Presentation of financial statements", a premium would be recognised as earned income over the period of insurance and, to the extent that this period bridges the end of an accounting period, it will be necessary to carry forward as at that date a proportion of the premium as unearned. By adopting this accounting practice the premium is treated as earned over the duration of the risk.

31. For the majority of policies or contracts the level of risk does not fluctuate to a substantial extent during the risk period and in these circumstances premiums may be regarded as having been earned evenly over the risk period. Accordingly, unearned premiums would be determined on the basis of time apportionment of the written premiums.

32. For direct business and inward reinsurance the method used would be no less accurate than the monthly pro-rata method. For inwards treaty reinsurance, the method used will reflect the frequency of treaty reinsurance reports received.

33. When the level of risk is expected to fluctuate significantly during the risk period - for example in the case of seasonal risks such as typhoon - a basis other than time apportionment of the written premiums may be appropriate. The basis to be used would reflect the pattern of the incidence of risk during the period of insurance.

34. The unearned premium would be calculated separately for gross and outward reinsurance premiums. In calculating the unearned outward reinsurance premium care would be taken to ensure that only those reinsurance premiums which vary directly with the written premium are used in the calculation. Reinsurance, such as excess of loss and stop loss, which relates to a period of time would be expensed over that period.

35. If the risk exposure period extends for more than one year, the total written premium would be accounted for immediately and the portion not relating to the current accounting period would be included as unearned premium.

36. If an insurer receives direct business premiums by instalments, the total premium would be accounted for at inception of the policy and recognised over the period of risk in accordance with paragraphs 30 to 33.

Deductions

37. Premiums would be recorded after deduction of discounts but before deduction of acquisition costs.

38. Where premiums are quoted on a net basis and the amount of commission deducted is not specifically stated, an estimate of the amount of the implied commission would be added back to the premium amount as notified and recorded as a commission expense. The nature of items deducted from the premium amount must be carefully considered in order to properly distinguish discounts from acquisition costs.

39. Where levies or fees are collected from the insured on behalf of a third party, the charge would not be recorded as premium or other revenue of the insurer. The charges due would be recorded as a liability due to the third party with effect from the date of risk acceptance.

Outwards reinsurance premiums

40. Outwards reinsurance premiums relating to a specific risk would be accounted for in the same accounting period as the premiums for the related direct or inwards reinsurance business being reinsured, and would be recorded before deduction of acquisition costs.

41. Outwards reinsurance premiums relating to a specific accounting period would be accounted for in the same accounting period.

Premium deficiency

42. Where the unearned premiums (net of any deferred acquisition costs) are expected not to be sufficient to meet the expected claims and related expenses relating to the remaining period of risk, a premium deficiency arises and a provision would be made at the accounting date.

43. Where an insurer discounts certain provisions for claims outstanding the same considerations used in discounting would be applied in the calculation of the premium deficiency. In particular the investment income of the assets allocated to the discounted claims provisions would be excluded from the calculation of the premium deficiency provision since this will have already been included in the discounting assumptions. In general investment income would only be taken into account where the type of business is long tail in nature.

44. The question of whether or not to set up a premium deficiency provision would be considered by an insurer on the basis of the underwriting experience of the aggregate of all classes of business being written. However in the preparation of the regulatory returns, the Valuation Regulation requires that a provision be made for each separate class of business.

45. When a premium deficiency provision is established, the amount of the provision would be calculated on the basis that deferred acquisition costs will not be amortised.

46. In the preparation of the regulatory returns, the application of the Valuation Regulation requires that deferred acquisition costs are assigned a nil value, however in the calculation of the premium deficiency it is still necessary that the deferred acquisition costs are taken into account when quantifying the amount of the premium deficiency.

47. There are two bases of presenting a premium deficiency provision:

    a. the shortfall in the unearned premium is first recognised by writing off deferred acquisition costs to the revenue or the income statement and, if the shortfall is greater than the amortised acquisition costs, a provision is made for the excess; or

    b. deferred acquisition costs are disregarded and a provision is made for the entire shortfall in the unearned premium with deferred acquisition costs being carried forward separately.

48. The first alternative is based on the theory that, where the recovery of deferred acquisition costs is in doubt, such expenses would be written off before any additional liabilities are recorded. The second alternative is based on the theory that although the unearned premium, deferred acquisition costs and the possibility of a loss arising in a subsequent accounting period in respect of existing business are related issues, the requirement for a provision for premium deficiency arises from independent circumstances related primarily to claims experience and accordingly the unearned premium and deferred acquisition costs would be considered separately.

49. The second alternative is preferable in that income and expenditure are properly segregated and, unlike the first alternative, it does not result in the distortion of operating ratios.

Financing arrangements

50. Financing arrangements would not be accounted for as general insurance business.

51. Financing arrangements would be accounted for as follows:

    a. The premiums paid by the cedent would be recorded as "amounts receivable under financing arrangements", and in the reinsurer's financial statements as "obligations under financing arrangements".

    b. The provision for claims outstanding purported to be the subject of the arrangement would be retained on the balance sheet of the cedent and continues to be accounted for in accordance with paragraphs 54 to 58.

    c. The difference between the amount of the recoveries and the associated cost of the arrangement would be brought to account over the period of the arrangement as investment income in the financial statements of the cedent, and investment expense in the financial statements of the reinsurer.

Underwriting pools and co-insurance

52. Insurance business allocated through underwriting pools and co-insurance arrangements by an entity acting as an agent would be treated by the accepting insurer as if that business had been directly underwritten by the accepting insurer (or in respect of reinsurance business directly assumed by the accepting reinsurer).

53. Business directly underwritten by a member of an underwriting pool or co-insurance arrangement which is reinsured with such an underwriting pool or co-insurance arrangement would be treated as direct insurance business by the underwriting member as they are directly accepting the entire risk, and are therefore the primary risk carrier. The portion of that risk reinsured with other pool members or co-insurers, being the extent of the shares in the pool or arrangement held by other pool members or co-insurers, would be treated as outwards reinsurance by the underwriting member. The share of insurance business placed in the pool or arrangement that is taken up by a pool member or co-insurer would be treated as inwards reinsurance by the accepting pool member or co-insurer.

Claims

54. Provision would be made at the end of the period for the estimated ultimate cost of all claims not settled at that date including claims handling expenses, less amounts already paid, arising from events occurring during that period and whether or not notified before the close of the accounting period, and including current period adjustments to the provisions brought forward for claims occurring in previous accounting periods.

55. The provision for claims outstanding at the end of the period would include the insurer's estimated liability in respect of notified claims, claims incurred but not reported (IBNR) and claims handling expenses.

56. Whilst general insurance policies will normally specify the type of risks insured against and the cover provided, the amount of a claim under such a policy will not be certain but will depend upon the circumstances giving rise to the claim. Therefore there can be considerable uncertainty as to the actual liability in respect of a claim until all the relevant information has been collated. In the interim period it will be necessary to make estimates, and the provision for claims outstanding will necessarily be the result of a series of estimates and judgements which would be based on individual case estimates, statistical calculations and management judgement, as considered appropriate. The provision would be determined as accurately as possible, having regard to prudent assumptions about the final amount for which claims are expected to be settled. Some of the factors which would be taken into account include previous experience in claims notification patterns, changes in the nature and amount of business written, trends in claims frequency and variations in average incurred cost per claim, inflation and the latest available information at the time of the preparation of the financial statements (such as increases in court awards).

57. Particularly, for long-tail business where the notification of claims and their agreement and settlement are spread over a considerable period of time, it is advisable for the insurer to obtain actuarial advice on the adequacy of the related claim provisions.

58. Claims handling expenses would include indirect costs where such indirect costs can be reasonably estimated, an appropriate allocation of these indirect cost estimates to the future settlement of claims can be made and the resultant effect of such an allocation has a significant effect on the underwriting results from one accounting period to the next. Where indirect settlement costs have been included in determining the liability for claims outstanding, appropriate indirect acquisition costs would be included in determining deferred acquisition costs.

Claims recoveries

59. Claims recoveries from reinsurers and other recoveries yet to be received (e.g. salvage, subrogation) would be accounted for in the same accounting period as the underlying claims.

Portfolio premium

60. Portfolio premium would be accounted for as outwards reinsurance premium by the transferring insurer and as an inwards reinsurance premium by the accepting insurer.

Portfolio claims

61. For direct insurance business, portfolio claims would be accounted for by the transferring insurer as claims recoverable, and the related claim liabilities would be retained in its accounts. The accepting insurer would account for the portfolio claims received as recoveries relating to the cost of the outstanding claim liabilities assumed, and not as premium revenue.

62. In relation to the transfer of direct insurance business, while 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, therefore the related liabilities would remain on the books of the transferring insurer, and be appropriately adjusted in future accounting periods.

63. In relation to the withdrawal of a reinsurer from a portfolio arrangement, the contractual responsibility of the reinsurer to the direct insurer in relation to claims outstanding will depend on the terms of such a release and may be passed back to the direct insurer or on to another reinsurer, or else may be retained by the withdrawing reinsurer.

64. Where a reinsurer transfers a loss portfolio to an accepting reinsurer or back to the original ceding insurer then the consideration paid would be accounted for by the transferring reinsurer as settlement of the claims outstanding as recorded in its accounting records. Any difference between the consideration paid and the amount of the claims outstanding would be recorded by the transferring reinsurer as an adjustment to the claims expense. (Where the reinsurer retains responsibility, the accounting is the same as in the case of a transfer of direct insurance business in paragraph 62).

65. Where the original ceding insurer assumes responsibility for the liabilities arising from a portfolio claim previously transferred, the consideration received would be recorded in its accounting records as satisfaction of the claims recoverable from the transferring insurer under the terms of the original reinsurance treaty. Any difference between the consideration received and the amount recoverable would be adjusted to the claims expense of the original ceding insurer.

Discounting

66. When determining the provision for claims outstanding, there is also a view that the amount will not necessarily be the full amount of the liability. This is because income may be earned on the amount retained before the liability is settled, which can offset costs which are not included in the provision such as increases in claims costs due to price increases or future claims handling costs. Therefore, in the case of general business claims outstanding where there is expected to be a delay before the claims are settled, there is an argument that the provision would be discounted to take account of the investment income on the funds held to meet the liabilities.

67. In practice, the time taken to determine and settle a claim can vary from weeks, for example, in the case of material damage to twenty years or more, for example, in the case of industrial disease. Furthermore, some claims, such as those for certain classes of liability business, give rise to liabilities payable at regular intervals over many years. Where claims are notified, agreed and settled in a comparatively short time period, as with motor claims not involving personal injury, discounting may not have a significant financial effect. However, where the notification of claims and their agreement and settlement are spread over a considerable period of time, the effect is more likely to be material. Where there is a sound basis for the evaluation of the likely amounts and timing of claims, there is a case for discounting these liabilities to reflect anticipated future investment income by recording claims outstanding provisions and attributable direct claims handling expenses at the present value of anticipated cash payments. Where the inherent uncertainties in estimating future liabilities and the timing of the payment of them are significant, discounting would be imprudent.

68. Implicit discounting (i.e. an accounting practice which places a present day value on a claims outstanding provision without disclosure of that fact) is not allowed.

69. Explicit discounting is permitted only where the following conditions are met:

    a. the notification of claims and their agreement and settlement are spread over a considerable period of time;

    b. there is adequate past experience on which a reasonable model of the timing of the run-off of the liability can be constructed to facilitate the making of a soundly based evaluation of the likely amounts and timing of claim payments; and

    c. the effects of inflation and other factors have been fully taken into account in establishing the claim liabilities to be discounted.

70. The assumptions used in the discounting of the provision for claims outstanding would include an appropriate risk factor to take into account the uncertainties regarding the expected timing of payments, the ultimate claims liability and the expected investment return. It is further necessary that appropriate risk factors are built into the assumptions to reflect inherent uncertainties in the expected ultimate claims and the investment return. In particular, when assessing the expected increase in costs due to price rises, the inflation assumption adopted would reflect the future increases of the particular cost components of the relevant claims e.g. medical costs, salary costs and the impact of judicial awards. These will often give rise to an inflation rate which is higher than general price inflation.

71. Whilst past experience may provide an indication of such assumptions, it is essential that the assumptions are set on future expected experience, and would be reviewed at least annually in the light of any new conditions.

72. Where claims provisions are discounted, a separate assessment would be made of the discount applicable to the related reinsurance recoveries.

73. When claims have been discounted, investments would be valued at fair market value, and the investment income of the assets held to support the claims outstanding provision (including unrealised gains and losses) would be credited to the revenue account to match against the claim cost recorded on settlement of the discounted claim liabilities.

74. Under the requirements of the Valuation Regulation, an insurer must seek the prior approval of the Insurance Authority before discounting claims. When discounting claims, the Guidance Note for Actuaries for the Discounting of General Insurance Liabilities issued by the Insurance Authority in February 1999 would be followed.

75. Once an insurer adopts the discounted basis, this would be consistently applied from accounting period to accounting period. If an insurer alters its accounting policy for providing for claims outstanding from a non-discounted basis to a discounted basis or from a discounted basis to a non-discounted basis, the change would be dealt with as a prior year adjustment in accordance with the requirements of SSAP 2 "Net profit or loss for the period, fundamental errors and changes in accounting policies".

Claims equalisation and catastrophe reserves

76. Due to the uneven incidence of claims, and particularly isolated claims of a catastrophic nature, substantial variations can occur from year to year in the general insurance business results reported by an insurer. Insurers are required to maintain a minimum level of surplus assets, after providing for all known liabilities, as a solvency margin to cover principally any shortfall in the technical provisions, adverse fluctuations in asset values and unprofitable future trading. In practice most insurers maintain a solvency margin substantially in excess of the legal minimum, which is estimated to be sufficient to cover, inter alia, major fluctuations in claims experience and catastrophes when they arise. An appropriation of profits to claims equalisation and catastrophe reserves equivalent to that part of the solvency margin may be set aside to meet such fluctuations.

77. If such a claims equalisation and/or catastrophe reserve is maintained, the basis of the calculation of the reserve would be consistently applied in each accounting period, and the amount and method of calculation disclosed in the financial statements.

Expenses

78. Expenses would be identified according to the nature of the activity to which they are attributable: underwriting, claims handling, investment and others.

79. Appendix 2 provides some guidance on the classification of expenses. Underwriting expenses would be sub-divided into acquisition costs (being those costs incurred in the acquisition and renewal of insurance policies/contracts) and maintenance costs (being those costs incurred in servicing policies/contracts already in force). In particular, maintenance costs would include irrecoverable amounts due from reinsurers (which would not be netted off against premiums).

80. Acquisition costs would also include indirect costs where:

   a. such indirect costs can be reasonably estimated;

   b. an appropriate allocation of these indirect cost estimates to a future benefit to the insurer can be made; and

   c. the resultant effect of such an allocation has a significant effect on the underwriting results from one accounting period to the next.

81. Acquisition costs which directly relate to premium revenue that will be recognised in subsequent periods would be deferred and recognised as assets where the costs incurred represent a future benefit to the insurer which can be reliably measured. For this purpose it may be necessary to allocate acquisition costs to classes of business in order that the amount of acquisition costs to be deferred for each class of business may be determined. Such an allocation may not always be possible for inward reinsurance business since the ceding insurer, when advising the reinsurer of the unearned premium, may not include an amount for deferred acquisition costs. In these circumstances, and in the absence of specific advice, it will be necessary to estimate the amount of the acquisition costs to be allocated.

82. Other maintenance costs relating to underwriting activities would be included in determining the underwriting result for the accounting period.

83. Claims handling expenses would be charged in full against the revenue of the accounting period in which the related claims are incurred, i.e. claims handling expenses which are anticipated to become payable in subsequent accounting periods in relation to claims incurred in the current accounting period (whether these claims have been reported or not by the period end) would be provided for in the current accounting period as a component of the liability for claims outstanding and recorded as a claim expense.

84. Investment costs would be expensed as incurred where they relate to the purchase, handling, holding, managing and sale of all types of investments together with related staff and office costs. Interest would be considered to be an investment expense only where the interest has been specifically incurred in earning investment income (e.g. where interest is incurred on funds borrowed to purchase investments). Expenses such as stamp duty and brokerage, which are directly attributed to acquiring or disposing of an investment would be regarded as part of the capital cost of the investment, and not treated as investment expenses.

85. Other expenses would be expensed as incurred and included in the income statement for the period.

Fund accounting basis

86. All premiums and claims (including outwards reinsurances) notified in an accounting year would be accounted for in that year and attributed to the appropriate underwriting year.

87. A profit or loss is not recognised until the underwriting year is closed after two or more accounting years.

88. No specific provisions are created for unearned premiums and no estimates are made for pipeline premiums at the end of the open years.

89. It is essential that the fund carried forward, made up of amounts relating to various underwriting years both open and closed, is at all times sufficient to meet the estimated future liabilities in respect of each underwriting year.

90. Therefore, the net balance at the end of an open year together with the estimated future unrecorded income would be tested for adequacy in so far as this is possible against the estimated claims and other related expenses, including attributable claims handling expenses. The provisions set up for specific liabilities relating to closed years would also be assessed for adequacy in accordance with paragraph 89. If the fund to be carried forward at the end of an accounting period is considered to be insufficient to meet the anticipated liabilities, an amount will need to be added to the fund to cover the expected deficiency.

91. The amount required to be added to the fund would be transferred from the income statement. Transfers between different underwriting years, i.e. cross-funding, are not acceptable, but transfers between different classes of business within the same fund are acceptable if within the same underwriting year.

92. Where an amount has been added to a fund in an accounting period for an underwriting year, and at the end of a subsequent accounting period (other than that when the fund is closed) it is evident that the amount added to the fund for that underwriting year was excessive, a transfer out of the fund may be made up to but not exceeding the amount transferred into the fund at the end of the previous accounting period. Such a transfer would be made to the income statement.

93. A fund can consist of either one class or more than one class of business provided those classes are managed together.

Part 4 - Financial statement disclosure

Accounts presentation

Balance sheet

94. The assets and liabilities of an insurer need not be categorised between current and non-current on the face of the balance sheet. However in accordance with paragraph 55 of SSAP 1 "Presentation of financial statements", assets and liabilities would be presented broadly in order of their liquidity. In addition, and in accordance with paragraph 56 of SSAP 1, it is necessary that where asset and liability items combine amounts expected to be recovered or settled both before and after twelve months from the balance sheet date, then the amount expected to be recovered or settled after more than twelve months is disclosed. Further information on the maturity of assets and liabilities may be presented in the notes.

Income statement and revenue account

95. Details of the underwriting results for the reporting period would be presented in a revenue account, with the net underwriting result being transferred to the income statement. There the net underwriting result would be combined with the net result from investments and other shareholder activities to determine the net profit (loss) of the insurer.

96. If the income statement and revenue account are combined, it is still necessary to disclose all components of the underwriting result within the combined statement.

97. For reporting under Parts 4 and 5 of the Third Schedule to the Ordinance, it is necessary that a revenue account is prepared for each class of business.

98. An allocation of the investment results may be made between the revenue account and the income statement, distinguishing the investment results derived from the investment of premiums from those derived from shareholders' funds.

Statement of ~~recognised gains and losses~~changes in equity

99. This Guideline takes the view that an insurance company which takes advantage of the disclosure exemptions given in Part III of the Tenth Schedule to the Companies Ordinance need not prepare a statement of ~~recognised gains and losses~~changes in equity (as required by SSAP 1).

Cash flow statement

100. An insurance company is required to prepare a cash flow statement ~~In~~in accordance with SSAP 15 (revised) "Cash flow statements" ~~,an insurance company which takes advantage of the disclosure exemptions given in Part III of the Tenth Schedule to the Companies Ordinance is not subject to the requirements of SSAP 15 to prepare a cash flow statement. However, it should be noted that the Third Schedule to the Ordinance removes the majority of these exemptions and therefore financial statements prepared in accordance with the Third Schedule to the Ordinance would include a cash flow statement.~~

Disclosure

101. Appropriate disclosures would be made by a general insurer in compliance with the requirements of the Companies Ordinance, Statements of Standard Accounting Practice and the Ordinance where applicable. The disclosure guidelines which follow are recommended in addition to these requirements.

Balance sheet

102. In relation to the balance sheet separate disclosure would be made of the following:

a. the amount of unearned premium (without any deduction for deferred acquisition costs);

b. the amount of deferred acquisition costs (these would not be netted off against the unearned premium);

c. the amount of the provision for premium deficiency;

d. the liability for claims outstanding which includes claims incurred but not reported and the provision for claims handling expenses;

e. the reinsurance amount applicable to (d) above;

f. reinsurance recoveries receivable (net of provision for doubtful recoveries);

g. premiums receivable (net of commission receivable and provision for doubtful receivables);

h. other insurance balances receivable;

i. premium payables; and

j. other insurance balances payable.

103. Insurance assets and liabilities would not be netted off unless there is a specific legal right of offset.

Income statement

104. The following additional disclosures would be made on the face of the income statement:

a. gross premiums written;

b. underwriting results transferred from the revenue account (if separately prepared);

c. expenses not related to underwriting activities; and

d. investment income arising from investments not supporting technical provisions.

105. If the income statement and revenue accounts are to be prepared on a combined basis, the disclosure set out below relating to the revenue account would be included on the face of the income statement.

Revenue account

106. In relation to the revenue account separate disclosure would be made of the following:

a. gross premiums written, outwards reinsurance premiums payable, and net premiums written;

b. movement in the unearned premiums, as an addition to or deduction from net premiums written;

c. net premiums earned;

d. acquisition costs payable relating to gross premiums written, commissions earned on business ceded and net acquisition costs;

e. movement in deferred acquisition costs, as an addition to or deduction from net acquisition costs;

f. gross claims paid, and reinsurance and other recoveries receivable;

g. movement in claims outstanding, as an addition to or deduction from net claims paid;

h. net claims incurred;

i. indirect claims handling costs incurred in the period;

j. maintenance costs and other underwriting expenses;

k. investment income (net of investment expenses) attributable to the investments that have been allocated to support the technical provisions;

l. underwriting result;

m. income and expenses relating to non-underwriting activities; and

n. net investment income relating to the assets held, which is not supporting the technical provisions.

Accounting policies

107. In relation to the accounting policies adopted by the general insurer in the preparation of the financial statements, disclosure would be made of the following:

a. the accounting basis adopted. In the rare cases where the fund accounting basis is used, the classes of business involved and the extent of the time deferral for profit recognition would also be disclosed;

b. the basis on which premium revenue has been recognised, including:

   i. the date from which premiums are recognised as revenue (i.e. the date of risk inception); and

   ii the method used to calculate unearned premium for each major line of business;

c. the basis on which claims have been recognised, including a statement of the policies adopted with regard to:

   i. how reported claims have been evaluated;

   ii. how IBNR claims have been estimated;

   iii. how claims handling expenses have been estimated, including a statement as to whether or not indirect expenses are included;

   iv. how reinsurance and other recoveries have been estimated;

   v. the extent to which future expected rates of inflation and other relevant factors have been taken into account; and

   vi. the extent to which claims have been discounted;

d. the basis on which premium deficiencies have been assessed and accounted for, and whether investment income has been taken into account;

e. with respect to deferred acquisition costs:

   i. the nature of the acquisition costs deferred, including a statement as to whether indirect costs are included in the acquisition costs deferred or not; and

   ii. the method used to calculate deferred acquisition costs;

f. with respect to investments and investment income:

   i. the method of valuation used to determine the carrying value of investments in the financial statements;

   ii. where a market valuation is used, the treatment of unrealised movements in market value;

   iii. where a market valuation is used, the basis on which deferred tax liabilities have been recognised; and

   iv. the basis of the allocation of investments and related investment income between underwriting operations and other activities; and

g. with respect to financing arrangements, the method of accounting for the recoveries and associated cost of the arrangements.

Notes to financial statements

108. Disclosure would be made in the notes as follows:

a. material claims portfolio transfers, and financing arrangements. With respect to financing arrangements, the exact nature of each policy, together with the timing and amount of recoveries and associated cost. Where there are a number of policies similar in nature, materiality would be considered by reference to the aggregate amounts payable as premiums or recoverable under such policies;

b. with respect to unearned premium:

   i. provision relating to direct and reinsurance inwards business; and

   ii. provision relating to reinsurance outwards;

c. with respect to investment income recognised in the revenue account and income statement:

   i. total investment income (before deduction of investment expenses);

   ii. investment expenses; and

   iii. net investment income (net of investment expenses);

d. with respect to claims outstanding:

   i. gross claims reported but not paid and related recoveries;

   ii. incurred but not reported claims, gross and net; and

   iii. any claims handling expense provision;

e. details of the movement in the premium deficiency provision from one accounting date to the next;

f. where inflation has been taken into account in establishing the claims liability:

   i. the rates of inflation used; and

   ii. the mean term to settlement of the claims included in the liability for claims outstanding at the balance sheet date;

g. where claims liabilities have been discounted:

   i. the classes or groupings of business involved;

   ii. the methods applied, including:

      - range of discount rates used, and

      - the mean term of the liabilities;

   iii. treatment of the attributable investment income; and

   iv. the effect of discounting on the profit or loss before taxation for the accounting period and on the net assets at the end of the accounting period; and

h. the amount of pre-debit balance outstanding at the period end.

Part 5 - Note on legal requirements in Hong Kong

109. Under the reporting requirements of the Companies Ordinance, the following apply:

a. Paragraph 27(1) of the Tenth Schedule to the Companies Ordinance grants insurance companies certain exemptions from the disclosure requirements of the Schedule.

b. Paragraph 27(2) provides that an insurance company's wholly owned subsidiary, whose business is complementary to that of the insurance company, will be granted the same disclosure exemptions. A wholly owned subsidiary is defined in paragraph 27(4).

c. Paragraph 27(3) provides that the accounts of a company shall not be deemed, by reason only of the fact that they do not comply with any requirement of the Schedule from which the company is exempt by virtue of paragraph 27, not to give the true and fair view required by the Companies Ordinance.

APPENDIX 1

Explanatory notes

This Appendix does not form part of the Guideline and is intended to provide guidance to readers in understanding certain requirements of the Ordinance and SSAP 24.

Forms and statement prepared under Parts 8 and 9 of the Third Schedule to the Ordinance

1. The submission of the forms and statement under Parts 8 and 9 of the Third Schedule to the Ordinance is required to enable the monitoring of Hong Kong insurance business and ensures that sufficient assets are maintained in Hong Kong to meet the liabilities arising from this business. The requirement to maintain assets in Hong Kong does not apply to a general insurer authorized to write reinsurance business only.

2. The format of the forms and statement are specified in the Third Schedule to the Ordinance. The forms and statement include only specific financial information of the general insurer's business. The information therein does not represent a complete set of financial statements, nor are the auditors required to give a true and fair opinion on it.

3. Whilst the recommended practice set out in the Guideline needs to be applied in the preparation of the forms and statement the following considerations need to be taken into account when preparing the forms and statement:

   a. Hong Kong insurance business

      The financial information included in the forms and statement under Parts 8 and 9 is only in respect of Hong Kong business as defined in the Third Schedule to the Ordinance. In relation to direct and facultative reinsurance business this means where the risk was actually written in Hong Kong (i.e. the policy is issued, the proposal form is prepared, signed, submitted or received, or the risk is accepted in Hong Kong). In respect of treaty business, a policy is said to be Hong Kong business where the treaty is signed, accepted or the negotiation is concluded in Hong Kong, although if less than 25% of the risk arises in Hong Kong, it does not qualify as Hong Kong business.

      The implication is that the underwriting result shown in the forms under Part 8 will not necessarily agree to the results shown in the financial statements prepared under the Companies Ordinance and Parts 4 and 5 of the Ordinance, since non-Hong Kong business will have been included in these financial statements. Similarly the liabilities shown in lines 41 to 57 of Part 9 will only relate to the Hong Kong business.

b. Assets in Hong Kong

In respect of the assets to be included in lines 1 to 40 of the statement under Part 9, only Hong Kong assets as defined in the Eighth Schedule to the Ordinance are permitted to be included. However under section 25A(1)(b) other assets, guarantees or other arrangements in lieu of assets may be included if permission from the Insurance Authority is obtained in writing.
However it is worth noting that assets subject to any encumbrance or charge (other than a floating charge) are not allowed to be included.

c. Valuation Regulation

In determining the assets and liabilities to be included in the statement under Part 9 it is necessary to apply the Valuation Regulation. The Valuation Regulation aims at providing a standard and prudent valuation basis for the assets and liabilities of an insurer and ensuring a prudent spread of its investments for solvency purposes. The Valuation Regulation sets out the valuation methodology which must be applied to the various types of assets, as well as certain criteria which must be applied in the determination of liabilities, namely the discounting of claims is prohibited (unless the prior approval of the Insurance Authority is obtained), and a provision for premium deficiency must be made on a class by class basis where necessary, not allowing for offsetting against any surplus in other classes.

Insurers may apply under section 60(1) of the Ordinance to relax the requirements of the Valuation Regulation. In accordance with that provision, any relaxation granted should not be contrary to the interests of policy holders or potential policy holders and should not adversely affect the Insurance Authority's ability to carry out its supervisory functions under the Ordinance. In the case of insurers which are not incorporated in Hong Kong, the Insurance Authority will only grant relaxation to an insurer if it is satisfied that it is reasonably impracticable for the insurer to follow the Valuation Regulation having regard to its current modus operandi and the valuation regulations of its home country.

Investments

4. The accounting treatment and disclosure of investments in debt and equity securities are prescribed by SSAP 24 "Accounting for investments in securities". This standard prescribes a consistent framework for accounting for investments in securities. However it does give a choice of treatments for investments other than held-to-maturity securities. This gives rise to a number of issues which would be considered by a general insurer in the classification of their investment portfolio as follows:

a. Held-to-maturity

Investments in debt securities which are held-to-maturity are measured at amortised cost in the balance sheet and any realised profit or loss on disposal would be accounted for in the period in which the disposal occurred. In addition, where the insurer is not expected to recover the carrying value of the investment, a provision would be made and recognised as an expense immediately. This treatment is only permissible if the insurer has the express intention and ability to hold those debt securities to maturity.

General insurers may often hold a substantial portion of their portfolio in this type of investments since they are more conservative and less volatile than equities, and are more appropriate to match the long term nature of their liabilities.

However, whilst there may not be an intention to actively trade such securities, there may not be the specific intention to hold them to maturity given that their realisation may be dependent on when claims become payable which can be an uncertain event. Without the express intention to hold the debt securities to maturity it would not be permissible to classify them as held-to-maturity under SSAP 24.

If an insurer wishes to classify its debt securities as held-to-maturity, it may be necessary to analyse the expected claims payment pattern in order to purchase debt securities with a maturity pattern to match the cash flow needs. If this approach is adopted, in the event that there is an urgent need to sell some debt securities to meet cash flow needs, paragraph 12(g) of SSAP 24 does allow the sale of debt securities without calling into question the original intention to hold the securities to maturity. However, general guidance in SSAP 24 indicates that if, say over 10% of the portfolio in any year is realised, the held-to-maturity classification may not be appropriate. It is worth noting that in the event such activity occurs it is necessary to consider whether the classification of the whole held-to-maturity portfolio is appropriate.

b. Investments other than held-to-maturity securities

There are two possible treatments for investments other than held-to-maturity securities, i.e. benchmark and alternative treatments.

The benchmark treatment requires a further classification of investments into 'investment securities' and 'other investments'.

Investment securities are those securities which are intended to be held on a continuing basis, i.e. for a long period and for a specific purpose. With such investments there would be no intention to ultimately realise a capital gain, and in many instances such investments will be held for strategic purposes, such as when an insurer invests in a related broker. Such investments may be carried at cost subject to a write-down arising from a diminution in value which is expected to be other than temporary.

Under the benchmark treatment, all other investments are required to be carried at fair value in the balance sheet, with realised and unrealised holding gains and losses included in net profit or loss for the period.

The alternative treatment requires investments other than held-to-maturity securities to be carried at their fair values with realised gains or losses included in the net profit or loss for the period. The treatment of unrealised gains and losses is dependent on whether the security is held for trading purposes or not. If it is held for trading purposes, any unrealised gains or losses would be included in the net profit or loss for the period, where the definition of trading implies that the purpose of holding is to generate a profit from the short term price fluctuations. If the security is not held for trading purposes, such unrealised gains or losses would be recognised directly in equity until the security is disposed of or is determined to be impaired, at which time the cumulative gain or loss would be included in the net profit or loss for the period.

For most general insurers their investment portfolio will usually be held to support the technical reserves, in which case it will not be treated as a trading portfolio. However where surplus investments exist over and above the amount required to meet the technical reserves, it is possible that the securities are more actively traded in order to generate additional realised gains. In such circumstances the investments would be appropriately categorised when purchased, since paragraph 30 of SSAP 24 states that it is not permissible to reclassify trading securities while they are held. Even if an investment portfolio is segregated into a policyholders' fund and a shareholders' fund the same accounting treatment would be consistently applied by the insurer.

5. The overriding feature of the application of SSAP 24 to a general insurer is the necessity to perform a more detailed analysis of its technical reserves in terms of identifying the ultimate liability and the maturity pattern to ensure that the investment portfolio is appropriate.

APPENDIX 2

Classification of expenses

This Appendix does not form part of the Guideline and is included for illustrative purposes only.

1. Underwriting

a. Acquisition

The cost of acquiring and renewing insurance contracts may include the following:

Direct costs

- commission
- brokerage
- direct advertising or marketing for new business (identifiable to a particular product)
- premium taxes borne by the insurer

Indirect costs

- salary, accommodation and other costs of underwriting, sales, sales administration, new business and renewal department staff
- processing costs relating to new policies and renewals.

Acquisition costs exclude expenses such as those of general management and image marketing which are not primarily related to the acquisition of insurance contracts.

b. Maintenance

The costs associated with the maintenance of contracts already in force may include:

- policy endorsements
- risk reviews and surveys undertaken in accordance with the policy terms
- cost of maintenance and preparation of statistics and reports
- commission such as profit commission
- processing costs.

2. Claims handling

Expenses relating to the negotiation and settlement of claims may include:

Direct costs

- legal and survey fees connected with claims

Indirect costs

- salary, accommodation and other costs of claims handling department staff
- processing costs.

3. Investment

All expenses relating to the buying, holding and selling of all types of investments, including the salary costs and related expenses of the staff involved, their office space, computer usage etc., but excluding stamp duty, brokerage etc., which are part of the capital cost of investments and therefore would not be treated as investment expenses.

4. Others

a. accounting department costs

b. senior management salary costs.