PKF Littlejohn LLP

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Broking Insights

TREATMENT OF INSURANCE BALANCES BY INSURANCE INTERMEDIARIES UNDER FRS 102

The introduction of FRS102 has resulted in insurance intermediaries, and their auditors, needing to carefully consider the treatment of insurance balances in their financial statements, resulting from a number of enhancements within FRS 102 compared to previous UK GAAP.

Background

Under old UK GAAP, the treatment of insurance balances varied; however, the generally accepted approach to the presentation of insurance debtors, creditors and client or insurers' monies was to present these items on a gross basis in the financial statements, with the net position, reflecting the unearned commission within insurance debtors, and commission not yet drawn down from the client account.

The generally accepted approach was contrary to the legal relationship between an intermediary, its clients and underwriters which was disclosed within the accounting policies.

What is driving the change?

In addition to the general definition of an asset, FRS 102 also provides a definition of "financial assets".

FRS 102 defines financial assets as any asset that is:

- cash;
- an equity instrument of another entity;
- a contractual right to receive cash or another financial asset from another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.

In our view, clients' or underwriters' monies, and brokerage debts, fall within the definition of financial assets and should be recognised on the balance sheet/ statement of financial position.

Premium debts, net of commission, do not meet the definition of financial assets as, in general, the intermediary is acting as an agent in a contract between the insured and insurer. An exception here is the Marine Insurance Act 1906 which includes the provision that intermediaries are legally liable for premiums in respect of marine insurance policies, and therefore meet the definition of a financial asset.

Summary of treatments

We set out below our expectations of how elements of insurance transactions should be shown on the balance sheet/statement of financial position within the financial statements.

Transaction component	Treatment	Justification of treatment
Client or insurer monies	On	Intermediaries have sufficient interest in the risks and rewards associated with the monies held, including: • Influence over cash flows; • Ability to fund when operating a non-statutory trust account; • Rights to interest receivable; and • Named party on the bank account. The corresponding obligation to underwriters, or clients, should be recognised as a liability in the financial statements.
Commission fee receivables or payable	On	Intermediaries have a contractual right to receive or pay commission fees receivable or payable.
Funded premium or claim items	On	Intermediaries have a legal obligation to make good any shortfall to client monies in the event of default and, therefore, have sufficient interest in the risk and rewards associated with the funded debt.
Premium debt net of commission (other than amounts under the Marine Insurance Act 1906 as detailed below)	Off	Intermediaries do not have a contractual right to the net premium, acting as an agent between the client and underwriter.
Marine Insurance Act 1906 governed transactions	On	Section 53(1) of the Marine Insurance Act 1906 makes intermediaries liable for the payment of premiums in respect of marine insurance policies.

Irrespective of how insurance balances are shown on the balance sheet/statement of financial position, we believe intermediaries should disclose the gross insurance balances held within the notes to the financial statements, reconciling to the net insurance balance, to improve the user's understanding.

A specific requirement of FRS 102 is that an entity should disclose with a commentary, significant cash and cash equivalent balances held by the entity that are not available for use by the entity. In the context of an insurance intermediary we believe that it is helpful to disclose the split between the entity's own cash and monies held on behalf of clients and underwriters.

Practical implications

In accounting for insurance balances under FRS102, intermediaries should consider the potential impact this may have, as set out below.

Implication	Issue and potential impact
Presentation and accounting systems	Broking systems will need to be sufficiently robust to ensure they are able to identify the following, at a minimum, to ensure these are accounted for correctly: • Unearned commission levels; • Funded balances, whether voluntary or involuntary; and • Risks where the Marine Insurance Act 1906 applies.
Gross asset position	The omission of gross insurance premiums will lead to a significant decrease in the gross asset position, which may: • Impact certain covenants in place; and • Alter a user's view of the financial stability of the intermediary.
Margin calculation	Providing gross insurance balances, in conjunction with net commission balances, in the financial statements may provide a reader with sufficient detail to calculate sensitive commercial data such as commission rates.
Funding exposure	Significant levels of premium or claims funding will be more visible in the financial statements.

For more information, please contact one of the insurance broking team.

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