

SPECIFICS OF THE UNEARNED PREMIUM RESERVE IN THE ACCOUNTING OF COMMERCIAL INSURANCE COMPANIES

Jana Gláserová¹

¹ Department of Accounting and Taxes, Faculty of Business and Economics, Mendel University in Brno, Zemědělská 1, 602 00 Brno, Czech Republic

Abstract

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Commercial insurance companies are liable to create, on the basis of risks arising from the fulfillment of the object of their activity, technical reserves, which are used to cover liabilities arising to insurance companies from insurance and reinsurance activity. The paper focuses on the technical reserve which is, in accordance with the accounting-legal regulation, created obligatorily in commercial insurance companies – it is the unearned premium reserve.

The paper explores the role and place of this technical reserve in the accounting of the commercial insurance companies based on the analysis of its substance, i.e. the objective definition. The paper is based on the methodology of the accounting, evaluation and methods of determining the amount of the technical reserve which will affect the income from operations as well as income tax base of commercial insurance companies. The paper also studied the method of reporting of unearned premium reserve in accounting according to Czech accounting legislation in comparison with International Accounting Standards (IAS/IFRS). The aim of this paper is to determine the impacts of the creation and application of the unearned premium reserve on some important items of the financial statements, which are mainly the income of operations, equity capital and balance sheet as well as to identify the impacts of different reporting of this reserve according to Czech accounting legislation and in accordance with IAS/IFRS. Performing the analysis of the accounting-legal regulation of the unearned premium reserve in the insurance companies, the analysis of the method of accounting of this reserve and also the comparison of reporting of this reserve according to both mentioned regulations is a prerequisite for the fulfillment of the aim.

Keywords: accounting, commercial insurance companies, unearned premium reserve, the principle of precaution, financial statements, income from operations

INTRODUCTION

Entrepreneurial activity is always associated with certain risks and uncertainties, which must be reported in the accounting in accordance with the requirements of accounting principles. The creation of reserves is one of the manifestations of the principle of precaution. The practical realization of this principle in the financial statements lies in the fact that the reported foreign resources and costs should not be underestimated.

The reserves should be approached from two perspectives. The primary is the accounting aspect

– the practical application of accounting principles is intended to fulfill the requirement of the true and fair reflection of reality. The secondary aspect is based on the Act on Reserves for the finding of income tax base and it is not significant for the accounting expression (Gláserová, Vávrová, 2013).

Reserves are reported in the accounting when the following facts are fulfilled: the company has a current liability as a result of a past event, the amount of the liability can be reliably estimated and the settlement of this liability will result in an

outflow of funds of the company (Accounting II, 2004). This definition is consistent with the concept of reserves according to IAS/IFRS, which define reserves as liabilities of uncertain time definition or amount (IFRS 2013, Red Book).

Kovanicová (2006) adds that reserves are the retained amounts, used both for potential risks (to exchange rate losses, losses from business, etc.) as well as for specific future costs (e.g. for repairs of tangible assets).

Reserves may be classified according to several aspects, see Double-entry accounting (2009). For example they can be classified according to their definition to the general reserves (designed to cover risks and losses from business, to business risk) or to specific reserves (for repairs of tangible assets, for the income tax, for restructuring, for pensions and similar liabilities).

Reserves can also be created during several fiscal periods before the creation of the expected cost and the company is gradually including the amount, which represents the amount of expected cost into the cost of the individual fiscal periods. Necessary resources for future expenses in the form of reserves are created in this way. These facts show that reserves are foreign resource of financing the business activities, as items they are therefore in liabilities in the balance sheet, in the part of foreign resources.

Sedláček (2005) points out that reserves as foreign resources of financing are expressing the debts of the company to the next period or eventually the next few periods. Therefore some reserves have short-term nature, other long-term. According to Bokšová (2010) reserves represent deferred part of profit (in terms of reporting lower amount of profit) applicable for the financing in the future and that is why in some publications they are regarded rather as their own sources and especially as a result of the method of creation of the reserve.

Reserves are generally created in frame of the financial statements, i.e. at the end of the fiscal period, as indicated by the Business Accounting (2009). It is appropriate to specify exactly the titles for the creation of reserves, reasons of the creation, amount and the method of their creation and use in the internal regulations of the accounting entity.

Accounting of the reserves should be regulated by the internal regulation of the company or eventually by the statutory instruments, if we are speaking about statutory reserves (Ryneš, 2011).

The reserves include also the technical reserves in the commercial insurance companies. From the accounting point of view, the technical reserves represent the evaluation of the future liabilities of the insurance company arising from its insurance and reinsurance activity. They are likely or certain, but their amount or the moment to which they arise are uncertain. Their amount is determined so that at each time point it would be sufficient to that extent that the insurance company would be able to meet its liabilities arising from insurance contracts. Insurance Act explicitly sets the liability

to create technical reserves for the fulfillment of the liabilities from the performed insurance or reinsurance activity to the commercial insurance companies.

Ducháčková (2007) justifies the existence of the technical reserves as an essential part of the economy of the insurance companies, which occur as a result of long-term nature of process of insurance.

Technical reserves of life and non-life insurance represent the most important item of the liabilities in the balance sheet of the commercial insurance companies. Foreign sources indicate that the technical reserves represent 80% up to 90% of the liabilities (Huleš, Hornigová, 1997).

AIM AND METHOD

The aim of this paper is to determine the impacts of the creation and application of the unearned premium reserve on some important items of the financial statements, which are mainly the income from operations, equity capital and total assets and also to identify the impacts of different reporting of this reserve according to Czech accounting legislation and in accordance with IAS/IFRS. This paper is a reflection and discussion of the author over the problem whether the technical unearned premium reserve in the accounting of commercial insurance companies fulfill the definition of reserves in the literal sense.

Performance of the analysis of the accounting-legal regulation of the unearned premium reserve in the commercial insurance companies, the analysis of method of accounting of this reserve and also the comparison of reporting of this reserve according both mentioned regulation is a prerequisite for the fulfillment of the aim.

The starting point for exploring the outlined problem is the analysis of legislation regulating the issue of the unearned premium reserve in the Czech Republic, in particular the Act on Accounting No. 563/1991 Coll. in current version, Act No. 277/2009 Coll., on the Insurance Industry, Act No. 593/1992 Coll. On Reserves for the finding the income tax base, as well as Decree No. 502/2002 Coll., of Ministry of Finance, which implements certain provisions of Act No. 563/1991 Coll., on Accounting, as amended, for accounting units that are insurance companies, as amended, and Czech Accounting Standard No. 207 – Technical reserves in non-life insurance and life insurance. International Accounting Standards – mainly IAS 37 – Reserves, Contingent Assets and Contingent Liabilities and IFRS 4 – Insurance Contracts regulating monitoring issues are also used.

Specialized publications addressing the monitoring issue in the Czech Republic are other mainly used sources.

Methods based on the principles of logical thinking, in particular the method of deduction, are used in addition to the scientific methods,

which are the methods of description, comparison and mainly analysis, in the paper. Synthesis method for the purposes of the formulation of proposals and their own conclusions is used in the final part of the paper.

RESULTS AND DISCUSSION

1 Unearned Premium Reserve as a Part of Technical Reserves in Accounting of Commercial Insurance Companies

The unearned premium reserve is created in the commercial insurance companies to the life as well as to the non-life insurance, except the life insurance with single premium. The amount of this reserve correspond to the part of the prescribed premium which is timely related to the next or a later fiscal period, and it is defined as the sum of these parts of the premium calculated according to the individual insurance contracts.

In terms of the method of calculation of technical reserves it belongs to a group of reserves that are allocable to individual insurance contracts, so they can be clearly attributed to a specific contract of life or non-life insurance.

According to Bokšová (2010), Cipro (2002) the unearned premium is a part of the premium, by which the insured person purchased insurance coverage for the following period. It arises when the insurance period do not correspond to the fiscal period. Jindra (2012) indicates the unearned premium reserves as so called forwarding of premiums, i.e. as reserves for premiums of other periods.

In accordance with Czech accounting legislation, the commercial insurance companies report all premiums received from clients as revenues from the current fiscal period. This amount of revenues must then be modified with the aim that only the amount relating to this period through the creation of unearned premium reserve would remain in the revenues of the current fiscal period.

This liability is based on the accrual principle, which is part of the accounting principles.

Unearned premiums do not occur only in these three cases:

- annual premiums fall at the beginning of the calendar year,
- quarterly premiums fall at the beginning of the calendar quarter,
- monthly premiums fall at the beginning of the calendar month.

2 Accounting Recording of the Creation and Application of the Unearned Premium Reserve

The creation of the unearned premium reserve is accounted for at the latest at 31.12., so at the closing date on the basis of internal accounting document under the competence to the life and non-life insurance charged to expense accounts. The use of this reserve is again accounted for no later than 31.12, so the closing date (of the subsequent accounting period(s)) on the basis of internal accounting document under the competence to the life and non-life insurance in favor of the revenues accounts. It is therefore a gross method of accounting. The use of the reserve means both its application and also its abolition. The use will automatically take place by the expiry of the time period for which the reserve was created in accordance with the insurance contract. It is different with the abolition of the reserve – the cause would be in the practice of the commercial insurances only the cancellation of the relevant insurance contract, under which it was accounted for the creation of the unearned premium reserve and at the time when this reserve was not depleted and at the same time the insurance company would return the unused premium to the client. There would not be the cancellation of the unearned premiums reserve in other case. This fact can also be seen as specific of the unearned premium reserve.

I: Overview of the technical reserves created in the commercial insurance companies in the field of life e non-life insurance

Technical reserve	Life insurance	Non-life insurance
Unearned premium reserve	YES	YES
Reserves for insurance benefits	YES	YES
Reserves for bonuses and discounts	YES	YES
Premium reserve for non life insurance	YES	YES
Other technical reserves	YES	YES
Premium reserve for life insurance	YES	NO
Reserves for life insurance if the insured is carrying the investment risk	YES	NO
Reserve for the fulfillment of the liabilities from used technical interest rate	YES	NO
Settlement reserve	NO	YES
Reserve for the fulfillment of the liabilities from the guarantee for the liabilities of the Czech insurers office	NO	YES

Source: own elaboration based on legal regulations

II: Accounting recording of the creation and application of the unearned premium reserve

Creation of the reserve		Application of the reserve	
Debit side of group account	Credit side of group account	Debit side of group account	Credit side of group account
50.,52. (Costs for life and non-life insurance)	441 (Reserves)	441 (Reserves)	60.,62. (Revenues from life and non-life insurance)

Source: own processing based on legal regulations

It is necessary in the analytical evidence kept in the accounting for unearned premium reserve to ensure separately monitoring of possible shares of reinsurers in the creation and use of reserves, transfers or transitions of reserves in connection with increases or decreases in portfolio of insurance and the change in reserves as the difference between its creation and use – this is the final balance of the reserve.

The unearned premium reserve, as well as all other technical reserves, is evaluated in accordance with the Act on Accounting at fair value.

3 Method of Definition of the Amount of the Unearned Premium Reserve

The unearned premium reserve, as the only technical reserve, is independent of the number of probabilities, i.e. its amount is clearly given by the amount of prescribed premium and the period for which the premium is determined.

Calculation of this reserve is based on the following relation:

$$\begin{aligned} \text{Amount of reserve} &= \\ &= \frac{\text{length of the period after 31. 12.}}{\text{length of insurance period}} \times \text{premium.} \end{aligned}$$

Czech Accounting Standard for insurance companies No. 207 recommends method of pro rata temporis (proportion to time) or method one to 24 method to commercial insurance companies in order to determine the amount of unearned premium reserve. Method of pro rata temporis is based on prerequisite of uniform distribution of risk during the insurance period and the unearned premium is calculated for each individual day of the year. In the Czech Republic it is based on the length of year – 365 days. This method works with precision on each calendar day of the year.

Čejková, Valouch (2005) consider the method of “pro rata temporis” as the basic method of the creation of the unearned premium reserve. One to 24 method is based on the assumption that all premiums in a given year have a common maturity in the middle of the month. When using this method, the maximum possible error is a half of month and it depends on the agreed maturity of insurance – whether it is in the first half or in the second half of the month. It is therefore less accurate method compared to the first mentioned method but in terms of time there would be a settlement and therefore the agreement in both used methods.

4 Impacts of Unearned Premium Reserve on the Significant Items of the Final Statements and on the Income Tax Base

In the first year, in the year of the creation of the reserve, this fact will affect both the balance sheet and the profit and loss statement. In the balance sheet there will be the increase in the balance sheet total in the amount of total premium received, which will be reflected in the assets in the form of cash resources and at the same time there will be revenues in this amount that will be reflected in the profit and loss statement. At the closing day due to the creation of unearned premium reserve there will be an increase in liabilities in foreign resources (reserves) in the amount of unearned premium and expenses in this amount will be recorder in the profit and loss statement. Positive income from operations (profit) in the amount of earned premium (the premium that applies to the current fiscal period) will appear both in the balance sheet and in the profit and loss statement as a result of this operation. There will be an increase in the equity capital of the insurance in

III: Summary of the impacts of the creation and application of the unearned premium reserve on the balance sheet

Accounting period	Impacts on balance sheet	Impacts on profit and loss statement
First year – the year of the creation of unearned premium reserve	Increase in balance sheet total (change in assets– increase in financial means– received premium, change in liabilities- increase in foreign resources – creation of unearned premium reserve, increase in equity capital – profit in the amount of earned premium)	Increase in income from operations in the amount of earned premium
Second and following years – the year(s) of the application of the unearned premium reserve	Change in structure of liabilities – decrease in foreign resources (unearned premium reserve) and contrarily increase in equity capital in the same amount in the form of positive income from operations.	Increase in income from operations in the amount of unearned premium

Source: own processing

the balance sheet since the income from operations is included in the equity capital.

In the second year, possibly subsequent fiscal periods, both of the basic accounting statements will be again affected. The balance sheet total will be maintained, however, due to the use of the unearned premium reserve there will be change in the structure of liabilities, namely there will be a decrease in foreign resources (reserves) and increase in equity capital in the form of positive income from operations in the amount of unearned premium. In the profit and loss statement there will be displayed therefore revenues, in the amount of unearned premium, so the income from operations will be increased by this amount.

The unearned premium reserve, respectively its creation, must be first recognized in the accounting in order to be tax recognized. Afterwards according to the Act on Reserves for finding the income tax base it is recognized in the full amount in relation to its methodology of its determination.

This fact shows that the unearned premium reserve in the commercial insurance companies has exactly the same impact on the income tax base as on income from operations, which is accounted for in the accounting. Specifically therefore the creation of this reserve will cause a decrease in the tax base in the amount of the created technical reserves in that tax period in which the creation of technical reserves was accounted for. In contrast the use of technical reserves results in increase of the tax base in that tax period in which was accounted for this fact.

5 Method of Reporting the Unearned Premium Reserve in the Financial Statements in Accordance with Czech Accounting Legislation in Comparison with International Accounting Standards (IAS/IFRS)

The financial statements of insurance companies prepared in accordance with Czech Accounting legislation show different characteristics compared with the financial statements of insurance companies prepared according to IAS/IFRS. The differences can be identified both in the form and content of the accounting statements, but even in the definition of the parts of the accounting statements. Balance sheet, profit and loss statement, annex and statement of changes in equity capital are parts of the financial statements in accordance with Czech accounting legislation. The statement on financial position, statement of total income,

statement of changes in equity capital and statement of cash flows are included in the balance sheet in the context of IAS/IFRS. The first two mentioned statements prepared according to IAS/IFRS correspond to the balance sheet and profit and loss statement in the conception of Czech Accounting legislation. The Czech National Bank requires supervision over the commercial insurance companies within the Czech Accounting legislation – the commercial insurance companies should prepare and handle the cash flow statement in regular intervals, which is substantively identical to the statement of cash flows prepared according to IAS/IFRS.

Czech Accounting legislation leaves in the balance sheet in the liabilities (in the section of foreign sources) in terms of technical reserves the privileged position to unearned premium reserve – it is listed on the first line. It is reported on a gross basis and also the eventual share of reinsurers in this reserve. The net amount is created by the difference. In the profit and loss statement the unearned premium reserve is reported both in the part of the technical account of the life insurance and in the part of the technical account of non-life insurance in the form of the change of status of the unearned premium reserve (it is therefore a balance between creation and use of this reserve in the relevant fiscal period). Although the gross method for accounting for the creation and use of reserve is used within CAL, in the profit and loss statement there is indicated the balance of reserve – the difference between the creation and use, i.e. its final, current status.

In the case of the accounting statements prepared according to IAS/IFRS it is required detailed allocation (distribution) of unearned premium item within the annex to the accounting statements according to the specific classification.

6 Is the Unearned Premium Reserve in the Accounting of the Commercial Insurance Companies the Reserve in the True Sense?

In the truest sense it is not a reserve because from the basic definition of reserves (see above) results that the reserves are intended to cover liabilities arising to insurance companies from insurance and reinsurance activity. This fact in the case of unearned premium reserve is not directly and unambiguously fulfilled. From the specific definition of the reserve according to Czech Accounting legislation and also in accordance with

IV: Comparison of the reporting of unearned premium according to CAL and IAS/IFRS

Balance sheet – foreign liabilities		Loss and profit statement
CAL	Special item within technical reserve	Special items of the technical accounts of the life e non-life insurance
IAS/IFRS	Part of the total liabilities from the insurance	Part of the item of the net revenue from the insurance for the life e non-life insurance

Source: own processing based on legal regulation

International Accounting Standards results that reserves are recorded in the accounting in the cases when following facts are fulfilled: the company has a present liability as a result of a past event, the amount of the liability can be reliably estimated and settlement of this liability would mean the outflow of funds of the company. If we have to assess the fulfillment of those requirements, so the present liability as a result of the past event could be understood very broadly – and as providing any possible insurance payment on the basis of the insurance contract concluded in the previous moment. It is not necessary to determine the amount of liability (i.e. the amount of unearned premium reserve) by the estimation because its amount is very clearly given, it is the exact amount. The outflow of resources from the commercial insurance companies would be again only in the case of the payment of premiums from the relevant insurance contract.

The unearned premium reserve is the practical implementation of accrual principle of accounting, which states that costs and revenues should be accounted for in the period to which they relate in terms of time and fact.

In terms of accounting methodology it is clearly a form of the accrual. However this method of recording the part of the received premium would

not be in accordance with the requirements of the treatment of assets in commercial insurance companies, which is understood as investing activities. Commercial insurance companies must funds from collected premiums from clients “insert – invest” through the market into assets of the other material (factual) form. The aim of the insurance is to invest the funds from collected premiums in such assets, which will bring the maximum appreciation of these resources. At the same time, however, the insurance companies are limited by law which determines the structure of financial investments and limits of the selected items. Securities and deposits, i.e. financial assets, are the most common factual form of investments.

Influencing the income from operation and tax base in case that the unearned premium is solved in the practice of commercial insurance companies in accordance with applicable accounting-legal legislation in form of reserve is identical in all affected fiscal and tax period with the possibility of solving the unearned premium in the form of classical accrual. Also the impact on the significant items of the financial statements is the same with the exception that reserve and accrual will appear within the foreign resources in the liabilities of the balance sheet in the other special items.

SUMMARY

Commercial insurance companies as business entities are carrying a large number of special activities. A specific chart of accounts, including accounting practices, has been created for this purpose in the Czech Republic. It was published by the Ministry of Finance of the Czech Republic in the form of Decree No. 502/2002 Coll., implementing certain provisions of Act No. 563/1991 Coll., on accounting, as amended, for accounting units that are insurance companies.

The paper deals with problems of the specific technical reserve in insurance companies, which is the unearned premium reserve. Technical reserves represent a specific item in the liabilities in the balance sheet of the commercial insurances, they are used to cover the liabilities arising to the insurance companies from insurance and reinsurance activities. They are a practical application of the accounting principles – principles of precaution, accrual principle and fair reflection of reality. The unearned premium reserve has a privileged position within the technical provisions. It is presented as a particular item of the technical reserves in the balance sheet in the first place and, similarly, separately in the profit and loss statement.

On the basis of performed analysis of the definition of the nature of the unearned premium reserve and its accounting recording there have been determine the impacts of the creation and application of this reserve on the significant items of the financial statements and also on the basis of income tax. Attention is also paid to the comparison of reporting of unearned premiums according to Czech accounting legislation and international accounting standards. All the findings are summarized in the form of tables.

In the final part of the paper, the author tries to answer the question whether the unearned premium reserve is in the accounting of the commercial insurance companies the reserve in the literal sense or whether this is rather accrual in terms of accounting methodology.

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