Insurance brokers: Accounting for premiums receivable from policyholders

An insurance broker acts as the agent of policyholders or potential policyholders and is committed to provide its services in the policyholder's best interest at all times. Insurance brokers assist policyholders with assessing their insurance needs, negotiating with insurers for better terms and premiums, or advising on matters related to insurance.

In Hong Kong, an insurance broker generally collects insurance premiums from policyholders (i.e. gross premium amounts), including the portion of the premium that would cover its commission, and then remits the premiums to the insurer after taking or deducting the commission due (i.e. net premium amounts). This article discusses whether an insurance broker should recognize premiums receivable on its statement of financial position when an insurance policy is placed. This article does not cover other accounting matters such as when commission income should be recognized as revenue and how client monies should be accounted for in a broker's financial statements.

In this article, premiums receivable refers to premiums that a policyholder owes under an insurance policy before deducting a broker's commissions, i.e. the gross premium amounts.

Overview of the insurance broking business

An insurance broker usually enters into a client agreement with a prospective policyholder when undertaking to find the appropriate insurance policy. The client agreement may be in the form of a Terms of Business Agreement, Client Engagement Agreement or other similar documents all aiming at governing the conduct of insurance business between a broker and a prospective policyholder. The client agreement may stipulate that the broker's commission is a percentage of the insurance premiums, and the percentage is usually agreed by the insurer with whom the insurance contract is placed. A broker is usually authorized to retain its commission upon receipt of the premiums and to remit the net premiums to the insurer.

Prior to or at the time of placement of an insurance policy, an insurance broker and an insurance company may also agree on the administration of the insurance policy such as collecting premiums and handling any insurance claims under the policy. These provisions are usually stipulated in a service agreement between an insurance broker and an insurance company.

Generally, an insurance broker issues a "notice of premiums due" to the policyholder when the policyholder and the insurance company are contractually bound under the terms of the insurance policy. This notice informs the policyholder that a premium is due under the insurance policy. A gross premium amount is usually quoted as a single amount from which the insurance broker would deduct its commission, as agreed with the insurance company. The broker collects the gross premiums from the policyholder and subsequently remits the premiums (net of commission) to the insurance company.

When a notice of premiums due is issued by the broker (step 4 of the diagram on page 49), a key accounting question is whether the broker should recognize in its financial statements:

1. A premiums receivable due from the policyholder; and
2. A payable to the insurance company for the net premiums due that are yet to be collected.

If it is determined that the transaction should be recognized, the questions of "when" and "how much" would follow.

Current practice in accounting for premiums receivable from policyholders

In practice, it is observed that two different approaches have been used by brokers to account for premiums receivable in their financial statements.

One approach is known as the "gross approach" whereby:

- The premiums and commission due from policyholders are recognized as receivables when the insurance contracts are placed and the notices of premiums due are sent to policyholders; and
- The corresponding uncollected net premiums due to insurance companies are recognized as a payable.

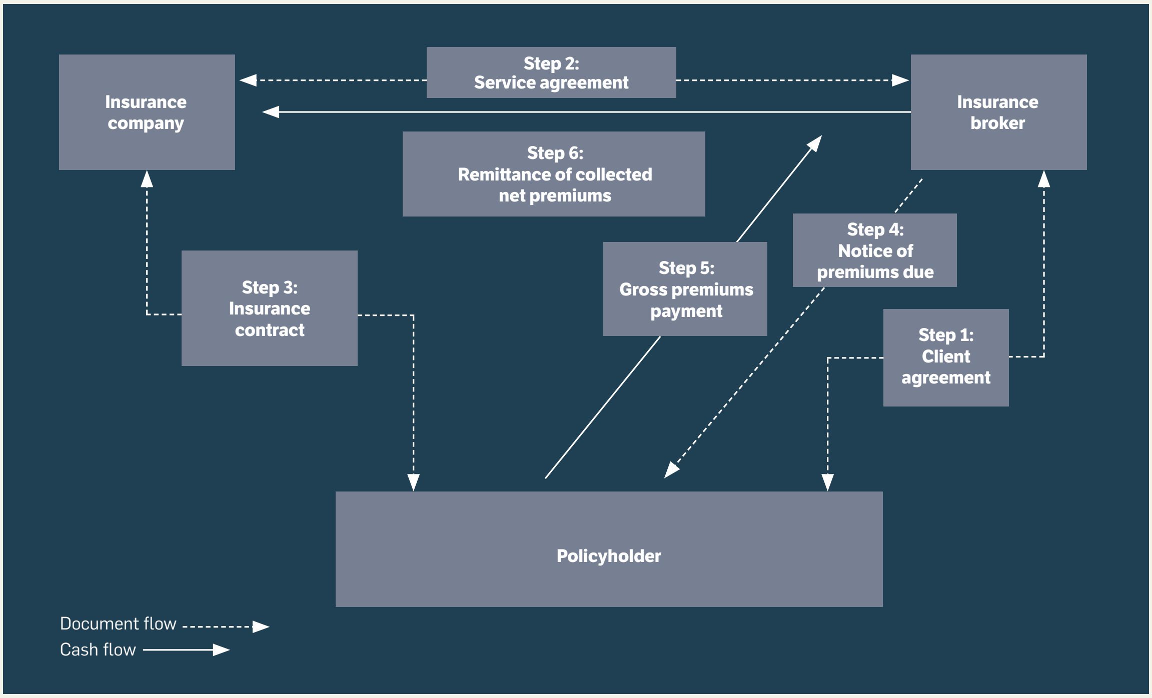
Another approach is known as the "net approach." Under this approach, only the commission due from policyholders are recognized as a receivable.

It is crucial to carefully analyse the contractual terms and conditions and the economic substance of the arrangement among brokers, policyholders and insurance companies when determining the appropriate accounting treatment for premiums receivable from policyholders.

What the standards say

HKAS 32 *Financial Instruments: Presentation*, paragraph 11, defines a financial instrument as: "...any contract

Transaction flows between a broker, an insurance company and a policyholder



that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity."

"A financial asset" is any asset that is:

(a) Cash;
(b) An equity instrument of another entity;
(c) A contractual right:
  (i) To receive cash or another financial asset from another entity; or
  (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
(d) A contract that will or may be settled in the entity's own equity instruments...

"A financial liability" is any liability that is:

(a) A contractual obligation:
  (i) To deliver cash or another financial asset to another entity; or
  (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
(b) A contract that will or may be settled in the entity's own equity instruments...

HKAS 39 *Financial Instruments: Recognition and Measurement*, paragraph 14, states that an entity shall recognize a financial asset or a financial liability on its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument.

The standards therefore require a broker to recognize amounts receivable if the broker has contractual right to payment. When determining whether to recognize a payable to an insurance company for uncollected premiums, a broker should assess whether it has a contractual obligation to an insurance company in relation to the premiums.

Analysis

The primary role of an insurance broker is to bring about a contract between a policyholder and an insurance company.

Insurance contracts specify:

- An insurance company's obligation to deliver insurance services to a policyholder in return for consideration (i.e. premiums). Therefore an insurance company usually has the contractual right to receive the premiums from policyholders and a liability for providing insurance coverage; and
- A policyholder's obligation to pay the premiums to the insurance company in return for insurance coverage from an insurance company. Therefore, a policyholder usually has the contractual obligation to pay the premiums to the insurance company.

Unless a contractual right to receive the premium from a policyholder and a contractual obligation to settle the premium with an insurance company arise from another contract, the broker does not recognize a financial asset for premiums receivable nor record a corresponding payable for uncollected premiums when the insurance company and the policyholder have entered into an insurance contract with each other. When a notice of premiums due is issued by the broker, the broker only recognizes commission receivable from a policyholder if the broker has an unconditional

right to the commission in accordance with the client agreement (i.e. when the revenue recognition criteria under HKAS 18 *Revenue* or HKFRS 15 *Revenue from Contracts with Customers* are met).

Consider this example. A policyholder agrees to pay a total of HK$1,000 for a medical insurance policy placed with XYZ Insurance Company. Broker A negotiated the premiums with XYZ Company on the policyholder's behalf. Broker A and XYZ Company have also agreed that Broker will be compensated with a commission of HK$200. The service agreement between Broker A and XYZ Company stipulates that Broker A collects the premiums the policyholder owes but does not have a contractual right to receive the premium under the medical insurance policy. Broker A issues a notice of premiums due of HK$1,000 to the policyholder (step 4 of the diagram on page 49). No amounts will be recognized by Broker A at this point unless the revenue recognition criteria are met. If revenue recognition criteria are met, Broker A recognizes HK$200 as a receivable for its commission as its right to payment was established in the client agreement.

As mentioned earlier, an insurance broker holds premiums paid by policyholders before passing them onto an insurance company (step 5 of the diagram on page 49). Brokers should consider how these client monies are accounted for in the financial statements. The October 2016 issue of *A Plus* provides more detailed discussion on the indicators that help an entity to determine whether client monies should be recognized on its financial statements.

Continuing the example above, when Broker A collects the premium of HK$1,000 the policyholder owes under the insurance policy, it should consider whether the HK$800 could be recognized on its financial statements. The HK$200 will either be recognized against the receivable (if it was recognized earlier) or credited to deferred revenue if the revenue recognition criteria have not yet been met.

Conclusions

The premiums due notice in itself (step 4 in the diagram on page 49) does not affect the accounting. The accounting depends on the broker's contractual rights and contractual obligations, and whether the revenue recognition criteria are met or cash is received. In summary:

1. If the premiums due notice is issued but no cash is received and the revenue recognition criteria are not met, then no accounting entries are made.
2. If the revenue recognition criteria are met, then a net receivable (i.e. for the commission only) and revenue are recognized.
3. If the revenue recognition criteria are not met but cash is received, then the net amount that is related to the commissions is recognized as deferred revenue. For the amount that is related to the net premiums (i.e. client money), a broker should only recognize the cash and the financial liability to insurer on its financial statement if they meet the recognition criteria under relevant HKFRSs.

Care should be taken when assessing a broker's contractual rights and obligations in an insurance broking transaction. Although this article discusses the accounting treatment of premiums receivable under the more general circumstances in Hong Kong, the accounting for premiums receivable may be different depending on specific facts and circumstances. Applicable laws and regulations should also be considered when determining the contractual rights and obligations of a broker. A broker should seek legal advice if there is uncertainty about its liability under its client agreements with policyholders and service agreements with insurance companies.