LASAAC
December 2005

# ACCOUNTING FOR INSURANCE IN LOCAL AUTHORITIES IN SCOTLAND

LASAAC

## Background and Introduction

Guidance entitled "Local Authority Funds for Insured and Self Insured Risks - Best Practice Guidance" was issued by LASAAC in 1995 to guide local authorities on the operation of insurance funds which arose from the Local Government etc (Scotland) Act 1994. Guidance on the accounting treatment however was provided in a separate document, "Local Authority Accounting Panel Bulletin No 13" which was issued in 1994.

Local authorities have since operated insurance funds on the basis of that guidance. There has been no change to primary legislation in the period since the issue of the 1995 guidance. Nor has there been fundamental change to the "Code of Practice on Local Authority Accounting in the United Kingdom – A Statement of Recommended Practice" (the SORP) as it applies to insurance or to the accounting entries which apply to reserves.

However, there has been recent debate in Scotland on accounting for insurance and LASAAC determined that it was appropriate to review the existing guidance. A key requirement was to ensure that it remained fit for purpose or, where appropriate, to modify the guidance accordingly.

There was also a clear requirement for LASAAC to reinforce the principle that direct reserve accounting was specifically precluded.

The purpose of this paper, which represents the results of the review, is to provide Scottish local authorities with modernised guidance on the application of the SORP on accounting for insurance in Scotland. It is intended to replace the Best Practice Guidance issued in June 1995.

The paper has been prepared by a LASAAC working group including the following Committee members, local authority practitioners and a representative from Audit Scotland:

Colin Duncan – Stirling Council

Graeme Mackenzie – Dundee City Council & ALARM

Paul O'Brien – Audit Scotland

Stephen Crichton – Glasgow City Council & LASAAC

Derek Yule – Aberdeenshire Council & LASAAC

Don Peebles – CIPFA

## Scope and Status of this Paper

This paper provides guidance for practitioners on the application of the SORP on accounting for insurance in Scotland. A particular feature of this guidance is to provide assistance to local authorities in complying with the prescriptive accounting requirement that expenditure should not be charged direct to a reserve.

This paper does not provide wider guidance on, nor indeed seek to comment upon, the appropriateness of any particular local authority's decision to operate an insurance fund. Clearly, that is a matter for each local authority.

## Legislative Framework for Insurance Funds

The legislative framework for the operation of a local authority insurance fund is set out in Schedule 3, Section 24 para (4) of The Local Government Scotland Act 1975 (the 1975 Act).

The Act refers to funds established for insurance and this was the subject of further primary legislation with the enactment of "Schedule 13 of the Local Government etc (Scotland) Act 1994" (the 1994 Act) which amended Section 22 of the 1975 Act by, inter alia, expressly introducing the following provisions in respect of the use of insurance funds:

> *"(ba) an insurance fund, to be used for the following purposes, namely-*
>
> *(i) where the authority could have insured against a risk but have not done so, defraying any loss or damage suffered, or expenses incurred, by the authority as a consequence of that risk;*
>
> *(ii) paying premiums on a policy of insurance against a risk"*

Primary legislation therefore provides the basis for the operation of insurance funds by local authorities. The legislation is however silent on the accounting treatment for insurance funds. Accounting treatment is determined by proper accounting practice under Section 12 of the Local Government in Scotland Act 2003. The SORP sets out proper accounting practice for the purpose of Section 12.

The SORP, in setting out accounting concepts and principles also describes a minimum disclosure requirement. The SORP properly however does not set out detailed guidance but states the following in respect of reserves:

*"Amounts set aside for purposes falling outside the definition of provisions should be considered as reserves, and transfers to and from them should be distinguished from service expenditure disclosed in the Statement of Accounts. Expenditure should not be charged direct to any reserve".*

The Committee recognises that there may be a tension between the definitive wording of the legislation, which would appear to imply that insurance premiums can be charged directly to the fund, and with the requirements of proper accounting practice which disallows direct reserve accounting. The primacy of legislation is acknowledged. It is however the intention of this paper to set out useful accounting guidance rather than to place an interpretation on the intention of a parliamentary draughtsperson.

## Operational Context

The operation of an insurance fund enables local authorities to determine the most cost effective method of managing and financing risk. This may mean that both self insurance and the purchase of external insurance feature. The cost of risk is charged to service departments by internal premiums which is the amount of funding required to contribute to the cost of managing that risk and will include external premiums, element of excess or self insurance and be adjusted for other factors such as previous losses.

An authority determines an appropriate level of "excess" for each type of insurance purchased, based on its assessment of risk and previous claims history.

Where an insurance fund is operated, it is good practice to obtain a regular independent valuation of the cumulative value of the fund relative to its known claims, outstanding liabilities and projection of incidents incurred but not yet reported. Where a valuation is considered appropriate, the period of review is a matter for each local authority.

Where a deficit arises as a result of an actuarial review this should be recovered from service departments over an appropriate period through an increase in the internal insurance premium or contribution from the service revenue account. The recovery period should be consistent with the valuation period.

## Accounting Context

Income and expenditure associated with the operation of an insurance fund include:

Income

- Initial contributions from the service revenue account to establish the fund
- Premiums charged to services
- Administration fees and recoveries
- Investment income on balances
- Recoveries from insurers, third parties and other agencies
- Contributions from the service revenue account to offset an identified cash deficit

Expenditure

- Consultancy fees
- Administration costs
- Statutory inspections
- Negotiation and payment of claims
- Payment of necessary legal expenses
- Purchase of insurance cover

It is emphasised that no item of income and expenditure should be directly debited or credited to the insurance fund. This guidance indicates that an insurance account should be maintained which should then be debited/credited as the items arise throughout the year. The account is distinguishable from the fund and the balance on the insurance account at the year end should then be transferred to the insurance fund as an appropriation.

An authority should not plan for a deficit in the fund. If a deficit arises then this should be recharged back to services in the year incurred as appropriate. Surplus balances on insurance funds should be invested in accordance with each authority's overall investment policies.

Service revenue accounts should be charged with

- The internal insurance premium
- Any deficit on the insurance fund
- Any impairment of an asset caused by a consumption of economic benefits e.g. fire damage

## Accounting Entries

This section sets out one method of accounting for insurance It is acknowledged that there may however be other methods or a further series of accounting entries which achieve the same purpose.

Local authorities should ensure however that where an alternative series of accounting entries is in fact adopted that direct reserve accounting is specifically avoided.

*Example 1: Insurance Premium Charges*

1

| | |
|---|---|
| DR | Service revenue account |
| CR | Insurance account |
| | Internal premium being charged to each service |

2

| | |
|---|---|
| DR | Insurance account |
| CR | Bank |
| | External premium being paid to insurance company (if any) |

*Example 2: Fire damage to a school*

1

| | |
|---|---|
| DR<br><br>CR | Service revenue account<br><br>Fixed assets |
| | Impairment loss being recognised |

2

| | |
|---|---|
| DR<br><br>CR | Bank<br><br>Insurance account |
| | Insurance proceeds being received from insurance company (if any). |

3

| | |
|---|---|
| DR<br><br>CR | Insurance account<br><br>Service revenue account |
| | Service reimbursed |

4

| | |
|---|---|
| DR<br><br>CR | Fixed assets<br><br>Bank |
| | Fixed asset being restated. |

5

| | |
|---|---|
| DR<br><br>CR | Insurance fund<br><br>Insurance account |
| | Balance on insurance account transferred to insurance fund at year end as appropriation |

*Example 3: Personal injury claim paid*

1

| | |
|---|---|
| DR | Bank |
| CR | Insurance account |
| | Insurance proceeds being received from insurance company (if any). |

2

| | |
|---|---|
| DR | Insurance account |
| CR | Bank |
| | Payment being made to claimant |

3

| | |
|---|---|
| DR | Insurance fund |
| CR | Insurance account |
| | Balance on insurance account transferred to insurance fund at year end as appropriation |

*Example 4: Provision for personal injury claim (where FRS 12 criteria met)*

1

| | |
|---|---|
| DR | Insurance account |
| CR | Provision |
| | Provision being recognised |

2

| | |
|---|---|
| DR | Insurance fund |
| CR | Insurance account |
| | Balance on insurance account transferred to insurance fund at year end as appropriation |

3

| | |
|---|---|
| DR | Bank |
| CR | Insurance account |
| | Insurance proceeds being received from insurance company (if any) in later year. |

4

| | |
|---|---|
| DR | Provision |
| CR | Bank |
| | Payment being made to claimant in later year. |

GLOSSARY

The following terms are in use for the operation of, and accounting for an insurance fund, and which have been used in this guidance.

| | |
|---|---|
| Claims Experience | A detailed record of all settled and outstanding claims within a period of insurance. |
| Excess (also known as Deductible) | The first part of each and every loss which is not met by the insurer, but has to be borne by the insured. |
| Impairment | A reduction in the value of a fixed asset below its carrying amount. |
| Premium | The consideration paid by the insured to the insurer in return for the insurance protection given. |
| Provision | Provisions are required where liabilities have been incurred but where timing or amount is uncertain. The specific conditions under which a provision is required are set out in FRS 12 as incorporated in the SORP. |
| Reserve | Amounts set aside for purposes falling outside the definition of provisions should be considered as reserves where the statutory power to hold a reserve exists, and transfers to and from them should be distinguished from service expenditure disclosed in the Statement of Accounts. Expenditure should not be charged direct to any reserve. See Provision above. |
| Risk | Any event, non event or uncertainty that may enhance or impede an organisation's ability to achieve its current or future objectives. |

| | |
|---|---|
| <u>Risk Financing</u> | Methods by which costs arising from adverse events and accidents, which may result in losses and/or claims for compensation, are met by an organisation. |
| <u>Self Funding</u> | Where the organisation itself decides to bear the losses, it may choose to meet the costs out of normal operating budgets, or create a fund or insurance reserve to meet these costs. See also <u>Risk Financing</u> above. |
| <u>Service Revenue Account</u> | Generic term used to represent the Consolidated Revenue Account and/or Housing Revenue Account |