

# CONSIDERATIONS CONCERNING THE EVALUATION AND RECOGNITION OF RISK INSURANCE ACCORDING TO IFRS 4

## CONSIDERAȚII CU PRIVIRE LA EVALUAREA ȘI RECUNOAȘTEREA RISCULUI DE ASIGURARE CONFORM IFRS 4

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**Abstract.** *The adoption of the IFRS 4 has the purpose to implement a common accounting language for the insurance companies, as well as for the sector operators, such as the accountancy problems consultants, auditors, economical-financial analysts, etc. Passing to IFRS does not involve only the accounting area, but has larger objectives that points to the strategic management of the insurance companies as well as the planning of the activities of these kind of societies.*

**Rezumat.** *Adoptarea Standardului International de Raportare Financiară IFRS 4 a avut ca scop implementarea unui limbaj contabil comun pentru societățile de asigurări, dar și pentru operatorii din acest sector, cum ar fi consultanții pe probleme de contabilitate, auditorii, analiștii economico-financiari, etc. Trecerea la IFRS nu a rezolvat numai problemele din domeniul contabilității, având obiective mult mai ample care au avut în vedere și managementul strategic al companiilor de asigurări, precum și planificarea activităților unor astfel de tipuri de societăți.*

The development of the world trade influences significantly the industry of the insurances, due to the appearance and development of the multinational corporations that consider the world as their private market and they try to place their production operations in the countries that offer economic advantages. In the same time, these corporations request cover in insurances valid across the world, which represents a challenge for the industry of the insurances. In this context, the insurance companies must develop their financial capacity and create administrative agreements in order to protect the major values that are exposed to damages. In the same time it is necessary to develop the set of intermediaries in insurances, of the offices of administration of the damage, as well as of the facilities offered by the reinsurance.

The creation of the free zone trade inside EU influences the insurance policy and the risk management through the appearance of the following opportunities and dangers:

- acting on a new market, free and with an important potential of growth of the profit and of the work places

- the possibility of the insurance company from other country to offer its products in all the member states of EU
- creation of the branches or subsidiary companies in all of the member states;
- the potential clients will be able to have access to the foreign insurance products;
- the increase of the competition that can have the effect of lowering of the insurance tariff practiced by some companies when they are very high with no justification;
- the tendency of standardization of the covered risks, the conditions and the terms of the insurance contracts;
- the tendency of consolidation of more European companies of insurance by acquisitions and fusions;

## **MATERIAL AND METHODS**

The purpose of this work is to underline the connection between the management of the risk of insurance, function of its nature and its assessment in the accounting according to the international standard of financial reporting – IFRS 4.

We are trying to show the manner in which certain decisions that must be taken regarding the prevention of the negative consequences determined by a bad analysis, administration and assessment of the risk of insurance can influence the economic and social value of the insurance companies.

The new demands of solvency for the insurance companies based on the risk represents one of the priorities for the European Union, and that is why in this article we aim to show what is the purpose of the monitoring of the solvency of the insurances, one of the main objectives of the management in view of keeping the financial autonomy, the flexibility of the administration, but also support of the decisions for financial straightening in the conditions that is necessary and imposed.

## **RESULTS AND DISCUSSIONS**

### **The nature of the risk in insurances and its classification**

A definition of the mere risk refers to the uncertainty of producing of an event that has as effect a damage irrespective of its nature, excluding the possibility to obtain any earning as a consequence of the occurrence of the mere risk, while the speculative risk refers to the uncertainty that the occurrence of an event that might have as effect either the obtainment of an earning or of a loss. Another classification of the risks involves the manner in which the occurrence of the uncertainty can modify in time.

The static risks are specified to an unchanged environment found in a stable balance (as the natural events: storm, lightning, flood etc.) the dynamic risks are the consequence of the environment modifications such as: social troubles, increase of the degree of technological complexity. These two types of the risks can be a mere risk as well as speculative. Another classification of the risks in insurances divides them into subjective and objective risks. The subjective risks refer to the appreciation of a person whose state of doubt or worry is caused by a given event. In essence the subjective risk

represents the uncertainty of psychological nature that is created out of the mental attitude or the state of a person.

The objective risks are different from the subjective risks by the fact that they can be noticed more precisely and, as a consequence, measurable. Generally, the objective risks represent the probable variation of an event or a state estimated based on the accumulated experience by a person. Also, the objective and the subjective risks are oriented as a priority to the effects of the production of the mere risks, on the persons and businesses.

### **Sources of production of the mere risks in insurances**

The risk regarding the property – any owner or user of mobile or immobile goods is submitted to the damage risk, destruction or robbery, as consequence of the occurrence of some natural events or human actions. The businesses can be affected by the potential losses of goods as consequence of some fires, explosions etc.

The risks regarding the civil responsibility – the persons as well as the companies can be responsible for the damage made to other persons or companies out of their fault. The actions in justice for the damage produced by the third parties, have as result the settlement of some important amount of money, for the compensation of the damaged parties as well as for punishing the ones responsible for that.

As a consequence, the physical persons as well as the companies must give special attention for the identification of all sources of risk of civil responsibility that might appear and assure the necessary measures in order to face the possible damages.

The risks regarding the persons / potential losses with the health of the persons represent the third category of the mere risks; for example the premature death of a person may have as effect, on one hand the loss of a certain amount of income of a family, and on the other hand, the appearance of some expenses for the funerals.

This event has negative consequences on the businesses of a company if it about a person of the top management, whose replacement is difficult to realize. The physical persons as well as the insurance companies are confronted with other risks associated to the health condition, such as the accidents and the illness that involves expenses with the medical treatment.

### **Methods of the risks assessment**

*The probability of producing damages* - represents the probability in time of appearing of the risk or the relative frequency of production of damages in a period of time. This method applies either for the probability of producing one event, either for a bigger number of events. The probability of producing damage is expressed as the report between the number of the damage and the great probability of appearances and the total number of possible damage in a certain group.

*Example:* 2500 buildings from a location are exposed to the risk of a landslide. Based on the previous experience it is known that 1000 of them will be affected by this event.

Solution

- probable number of damage = 1000
- total number of the buildings exposed to the risk = 2500

The probability of producing the damage= the probable number of damage/ the total number of the buildings exposed to the risk =  $1000/2500 = 4\%$

*So the probability of the damage productions of 4%*

The experience in the insurance sector shows that often there are conditions that have as effect the increase of the probability of production of the damage, in the situation of production of certain events or damages suffered in the case of production of the event, are much bigger that they were estimated.

*The degree of exposure to the risk*– can be determined as being the sum of the objective risks presented in a given situation, representing the relative variation of the estimated damages.

*Notations:*

Objective risk = RO;

Probable variation of the estimated damage = VPPE;

Total number of the estimated damages = Tpe;

According to these notations we have the following calculation relation:

$$RO = VPPE / Tpe$$

*Example:* In the locations X and Y there 25000 buildings, the medium annual average of the fires is of 250 in each location. Based on the statistics we can estimate that for the location X in the following year the fires number will be between 245 and 255, and in the city Y between 230 and 270. The degree of exposure to the risk (Gexpr) will be determined as follows:

For the location X -  $Gexpr = 255 - 245 / 100 = 10 / 100 = 10\%$ ;

For the location Y -  $Gexpr = 270 - 230 / 100 = 40 / 100 = 40\%$ ;

### **The Law of the big figures:**

In the case when the calculation of the degree of exposure to risk has no meaning for one objective, this becomes important in the situation of the increase of the number of exposed objectives to the risk.

The Law of the big figures reflects the fact that the loss that is the damage probably estimated is decreased as the number of the unities exposed to the risk increases. As a consequence, the degree exposure to risk decreases as the object exposed to risk increases.

*Example:* An enterprise X with chemical profile where the people work with toxic has 200 employees. Another enterprise with the same profile has 100 employees. The probability of the damage producing as a consequence of the risk exposure is 30 % in a year for each enterprise. In conclusion for the enterprise X, the total number of damage is: - for the enterprise X -  $0,30 \times 200 = 60$ .

- for the enterprise Y -  $0,30 \times 100 = 30$ .

Based on the statistics, for the enterprise X it was an average of 16 damages per year, and for the enterprise Y an average of 48 damages per year. Applying the method of the exposure risk, we find out that :

- for the enterprise X -  $Gexpr = 16 / 60 = 0,27$  or 27%;

- for the enterprise Y -  $Gexpr = 48 / 30 = 1,6$  or 160 %;

In conclusion, we can notice the fact that the degree of exposure to risk increases, the loss suffered being indirect proportional with the number of objectives in the situation of producing of a risk.

### **The management of the insurance risk**

Risk management is graduating from the tactical to the strategic, from the craft or the shopping for insurance coverage to the art of balance – sheet makeovers an information age decision – making

In the conditions which the risk sources can be identified, and the caused damages by the production of the risk can be estimated, certain decisions should be taken regarding the way of protecting the persons and the companies against the negative consequences of these risks. The process of the risk management must contain in the first place:

- identification of the risks – the management concentrating generally on the identification of the relevant exposures for the production of mere risks.
- the assessment of the risks- stage where the risks are classified function of the size of the quantum of the damage;
- the selection of the techniques and methods of management of the risk, respectively all the decisions for the administration of the identified risks;
- implementation of the decisions and their periodical review – the techniques and the methods previously selected must be put in practice and reviewed periodically in order to correspond to the possible modifications regarding the nature of the risk, the frequency of its producing, the gravity of the damage estimated.

### **The economic and social value of the insurance societies. The monitoring of the insurance solvency.**

The sum of the funds accumulated helps the insurance company to reduce the maximum possible damage. The cumulated liquidities of the insurers are invested, what allows a better allocation of the economic resources and the increase of the production. The bigger the investment funds are the more available is the capital on the market available at lower prices. The insurance companies can be involved actively in the prevention and decrease activities of the damage; they can contribute to the social stability and of the business environment, through the protection of the business and its persons.

The solvency – constitutes the capacity of the insurance company to face the dues on long and medium term and it depends on the size of the debts as a priority objective of the management of the insurance companies, that want to keep their financial autonomy and the flexibility of the administration and results from the balance between the cash of the insurance bonus and the payment flows of the damage. The solvency of the insurance company represents the ratio between the solvency margin that the insurance company disposes of and the minimum solvency margin.

The future activities of the insurer are uncertain, and the purpose of the solvency minimum margin is to guarantee that the insurer has sufficient assets in order to pay the future damage. Function of the ratio between the solvency margin that the

insurer has and the minimum solvency margin that determines the solvency degree of the insurer.

## CONCLUSIONS

If after the analysis of the financial reports and of the financial controls made, we can state that it is on the threshold of insolvency or it has a high risk of insolvency, what endangers the assumed obligations towards the insured, in this case we will request from the Administration Council to constitute and apply a plan of financial straightening that will have to foresee:

- the limitation of the volume of gross and net subscribed bonuses, on a period from 3 months to one year, so that these could not overpass the established values in the decision of opening of the straightening procedure;
- the interdiction of renew the contracts of insurance come to their finality, or as it is the case, of only a few types of insurance contracts established in the decision of financial straightening;
- the insurance company should make the transfer of the portfolio of insurances, totally or partially, under the legal conditions, in case this measure is disposed, the insurer will do the operations regarding the portfolio transfer as emergency in no more than 60 days from the date of the decision;
- the interdiction for the insurance company to make certain investments;
- the restraining of the territorial network of the insurance company by dissolution, under the conditioned of the law, in certain branches and subsidiaries, work units or other secondary locations, as well as the replacement of the significant persons that were identified as responsible regarding the start of the procedure of the financial straightening of the society has been decided.

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