Unearned Premium Reserves

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Unearned Premium Reserves (UPR or UEPR in some jurisdictions) is an item appearing in the liability portion of the balance sheet. It reflects the amount of premiums written but not yet earned. It is a technical reserve. Indeed, it has been said that "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."

It is among the several mandatory reserves required under the law. This reserve is for an unexpired risk. Loss reserves, on the other hand, is for an expired risk.

The unearned premium is "the premium corresponding to the time period remaining on an insurance policy", it is proportionate to the unexpired portion of the insurance. Unearned premiums are "portions of premiums collected in advance by insurance companies and subject to return if a client ends coverage before the term covered by the premium is complete" (see Section 80 of Insurance Code). They may be considered as deferred income. They are set aside in a reserve. Premiums are earned based on the amount of time which has actually elapsed under a contract of insurance. Specifically, premiums are earned when it is exposed to the risk covered.

The insurer has to maintain this reserve for unearned premiums (UPR) to meet the sudden need for cash in case a policyholder or the insurer decides to cancel the policy anytime during its tenure. All insurance companies have to maintain this reserve. In certain jurisdictions, the insurer maintains an added reserve called the Unexpired Risk Reserve. But this is not required under Philippine jurisdiction.

Unearned premiums appear in the balance sheet as liabilities because they are subject to refund to the client. As the insurer earns the premium, the amount earned is moved from the liability account to a revenue account in its income statement. It becomes earned only "when the policies are past their due." Thus, eventually, at the end of the policy, all premiums are earned.

Premiums are not recognized as revenues right away. They are not immediately considered as "premium income". They are recognized as revenues *pro rata* over the period of the policy. The UPR represent the unexpired portion of policy premiums.

The rationale for UPR was explained in the book *Theory and Practice of Ins*urance by J. Francois Outreville, "An insurance coverage is usually written for one year and the premium is payable in advance at the beginning of the period of coverage. Since the insurer is liable for all losses occurring during the period of the contract, the premium does not become fully earned until the contract has expired. In the annual statement of an insurance company, the unearned premium reserve would represent the proportion of the premium that is not earned by the company at the end of the accounting, fiscal, or calendar year. It is also referred to as 'reserve of unexpired risks.' For example, if a one-year insurance policy is issued on July 1, and if we assume that the fiscal and accounting year both end on December 31, then, only half of the premium is considered to be earned. Because the calculation of the unearned premium reserve on an individual policy basis would be, if not impossible, at least very uneconomical, formula methods have been developed."

In determining the earned premium, the length of the policy and the time that has elapsed are material. There several methods used in calculating the unearned premium reserve. A review of different jurisdictions would show that different methods are used by different jurisdictions.

The most basic formula is the flat rate method or the "40%" rule. It is still required in some jurisdictions. The "1/8ths" or the "8^{th}" method applies when reserving are done on a quarterly basis. In the Philippines, the 24^{th} method is now mandated under the Insurance Code. The pro rata temporis basis or the 365^{th} method is deemed to be the most accurate. The 365^{th} method assumes that risk is spread evenly over the 365 days of a year of cover. Thus, where a policy has elapsed for 100 days, $265/365^{th}$ of the premium is considered as being yet unearned.

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