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# Accounting by insurance and other enterprises for insurance-related assessments; Statement of position 97-3;

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

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**STATEMENT OF  
POSITION 97-3**

**AICPA**

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

*December 10, 1997*

**Accounting by Insurance  
and Other Enterprises for  
Insurance-Related Assessments**

American Institute of  
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*Issued by the  
Accounting Standards Executive Committee*

## NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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# SUMMARY

This Statement of Position (SOP) provides guidance on accounting by insurance and other enterprises for assessments related to insurance activities.

The SOP provides—

- Guidance for determining when an entity should recognize a liability for guaranty-fund and other insurance-related assessments.
- Guidance on how to measure the liability. It allows for the discounting of the liability if the amount and timing of the cash payments are fixed or reliably determinable.
- Guidance on when an asset may be recognized for a portion or all of the assessment liability or paid assessment that can be recovered through premium tax offsets or policy surcharges.
- Requirements for disclosure of certain information.

This SOP is effective for financial statements for fiscal years beginning after December 15, 1998. Early adoption is encouraged. Previously issued annual financial statements should not be restated. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, should an entity adopt the SOP prior to the effective date and during an interim period other than the first interim period, all prior interim periods should be restated). Entities subject to insurance-related assessments should report the effect of initially adopting this SOP in a manner similar to the reporting of a cumulative effect of a change in accounting principle. (Refer to paragraph 20 of Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes*.)

# FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (a) a prospectus for a project to develop a document, (b) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (c) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

- a.** The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
- b.** The proposal will result in an improvement in practice.
- c.** The AICPA demonstrates the need for the proposal.
- d.** The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

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# **Accounting by Insurance and Other Enterprises for Insurance-Related Assessments**

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## **Introduction**

1. Insurance enterprises as well as noninsurance entities are subject to a variety of assessments related to insurance activities, including those by state guaranty funds and workers' compensation second-injury funds. Some entities may be subject to insurance-related assessments because they self-insure against loss or liability. Current accounting practice is diverse among entities subject to such insurance-related assessments and related recoveries. Some of the diversity is a result of fundamental differences in the methods for assessing entities. Nevertheless, similar assessments are not being accounted for comparably among entities. A number of entities account for assessments on a pay-as-you-go (cash) basis, whereas others account for assessments on an accrual basis. Furthermore, the methods for accrual are varied.
2. As the prevalence and magnitude of guaranty-fund and other insurance-related assessments have increased, concern about the diversity in practice also has increased. This Statement of Position (SOP) provides guidance on accounting by entities subject to insurance-related assessments and was undertaken to reduce diversity in practice, improve the comparability of the amounts reported, and improve disclosures made by entities subject to guaranty-fund and other insurance-related assessments.

## **Background Information**

### **Guaranty-Fund Assessments**

3. States have enacted legislation establishing guaranty funds. The state guaranty funds assess entities licensed to sell in-

insurance in the state to provide for the payment of covered claims or to meet other insurance obligations, subject to prescribed limits, of insolvent insurance enterprises. The assessments are generally based upon premium volume for certain covered lines of business. Most state guaranty funds assess entities for costs related to a particular insolvency after the insolvency occurs. At least one state, however, assesses entities prior to insolvencies.

4. State guaranty funds use a variety of methods for assessing entities. This SOP identifies the following four primary methods of guaranty-fund assessments.
  - a. *Retrospective-premium-based assessments.* Guaranty funds covering benefit payments of insolvent **life, annuity, and health insurance enterprises** typically assess entities based on **premiums written** or received in one or more years *prior* to the year of insolvency.<sup>1</sup> Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.
  - b. *Prospective-premium-based assessments.* Guaranty funds covering claims of insolvent **property and casualty insurance enterprises** typically assess entities based on premiums written in one or more years *after* the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.
  - c. *Prefunded-premium-based assessments.* At least one state uses this kind of assessment to cover claims of insolvent property and casualty insurance enterprises. This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed prior to any particular insolvency and are based on the current level of written

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1. Terms defined in the glossary are set in boldface type the first time they appear in this SOP.



premiums. Rates to be applied to future premiums are adjusted as necessary.

**d. Administrative-type assessments.** These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency. These assessments are generally expensed in the period assessed and are not addressed further in this SOP.

- 5.** State laws often allow for recoveries of guaranty-fund assessments by entities subject to assessments through such mechanisms as **premium tax offsets**, policy surcharges, and future premium rate structures.

## **Other Insurance-Related Assessments**

**6.** Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are (a) to fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers' compensation board) and (b) to fund second-injury funds.<sup>2</sup>

**7.** The primary methods used to assess for these other insurance-related assessments are the following.

**a. Premium-based.** The assessing organization imposes the assessment based on the entity's written premiums.<sup>3</sup> The base year of premiums is generally either the current year or the year preceding the assessment.

**b. Loss-based.** The assessing organization imposes the assessment based on the entity's **incurred losses** or paid

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2. Second-injury funds provide reimbursement to insurance carriers or employers for workers' compensation claims when the cost of a second injury combined with a prior accident or disability is greater than what the second accident alone would have produced. The employer of an injured or handicapped worker is responsible only for the workers' compensation benefit for the most recent injury; the second-injury fund would cover the cost of any additional benefits for aggravation of a prior condition or injury. The intent of the fund is to help insure that employers are not made to suffer a greater monetary loss or increased insurance costs because of hiring previously injured or handicapped employees.

3. The assessing organization may be at the state, county, municipality, or other such level.

losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

## Scope

8. This SOP applies to all entities that are subject to guaranty-fund and other insurance-related assessments.<sup>4,5</sup>
9. Assessments covered by this SOP include any charge mandated by statute or regulatory authority that is related directly or indirectly to underwriting activities (including self-insurance), except for income taxes and premium taxes. This SOP does not apply to amounts payable or paid as a result of reinsurance contracts or arrangements that are in substance reinsurance, including assumed reinsurance activities and certain **involuntary pools** that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

## Conclusions

### Reporting Liabilities

10. Entities subject to assessments should recognize liabilities for insurance-related assessments when all of the following conditions are met.
  - a. An assessment has been imposed or information available prior to the issuance of the financial statements indicates it is probable that an assessment will be imposed.
  - b. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.

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4. Some entities are subject to insurance-related assessments because they self-insure against loss or liability. For example, one state specifies that self-insurers of workers' compensation should use as a base for assessment the amount of premium the self-insurer would have paid if it had insured its liability with an insurer for the previous calendar year.

5. This SOP does not apply to assessments of depository institutions related to bank insurance and similar funds.

- c. The amount of the assessment can be reasonably estimated.

### **Probability of Assessment**

11. Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable prior to a formal determination of insolvency.<sup>6</sup> Prefunded guaranty-fund assessments and premium-based administrative-type assessments (as defined in paragraph 4), are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second-injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

### **Obligating Event**

12. Because of the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may not be the event that obligates an entity. The following defines the event that obligates an entity to pay an assessment for each kind of assessment identified in this SOP.
13. For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming **obligated to write** or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if that insurance enterprise reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

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6. For purposes of this SOP, a formal determination of insolvency occurs when an entity meets a state's (ordinarily the state of domicile of the insolvent insurer) statutory definition of an insolvent insurer. In most states, the entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation.

14. For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

### ***Ability to Reasonably Estimate the Liability***

15. One of the conditions in FASB Statement No. 5, *Accounting for Contingencies*, for recognition of a liability is that the amount can be reasonably estimated. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provides that some amount of loss can be reasonably estimated when available information indicates that the estimated amount of the loss is within a range of amounts. When no amount within the range is a better estimate than any other amount, the minimum amount in the range shall be accrued.
16. Entities subject to assessments may be able to obtain information to assist in estimating the total guaranty-fund cost or the following years' assessments, as appropriate, for an insolvency from organizations such as the state guaranty fund associations, the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and the National Conference of Insurance Guaranty Funds (NCIGF). An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund will incur costs and pay claims that will determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of an insurance enterprise's future assessments.
17. If a noninsurance entity's assessments are based on premiums, it may be necessary to consider the amount of premium the self-insurer would have paid if it had insured its liability with an insurer. If a noninsurance entity's assessments are based on losses, it should consider the losses that have been incurred by the company when determining the liability. Most often, assessments that have an impact on noninsurance entities that self-insure workers' compensa-

tion obligations are for second-injury funds. Second-injury funds generally assess insurance entities and self-insurers based on paid losses. A noninsurance entity may develop an accrual for its second-injury liability based on one or more of the following: (a) the ratio of the entity's prior-period paid workers' compensation claims to aggregate workers' compensation claims in the state that was used as a basis for previous assessments, (b) total fund assessments in prior periods, or (c) known changes in the current period to either the number of employees self-insured by the entity or the number of workers who are the subject of recoveries from the second-injury fund that might alter total fund assessments and the entity's proportion of the total fund assessments.

- 18.** Estimates of loss-based assessments should be consistent with estimates of the underlying incurred losses and should be developed based on enacted laws or regulations and expected assessment rates.
- 19.** Estimates of some insurance-related assessment liabilities may be difficult to derive. The development or determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment. Examples of uncertainties follow:
  - Limitations, as provided by statute, on the amount of individual contract liabilities that the guaranty fund will assume, that cause the guaranty fund associations' liability to be less than the amount by which the entity is insolvent
  - Contract provisions (for example, credited rates) that may be modified at the time of the insolvency or alternative payout options that may be offered to contractholders that affect the level and payout of the guaranty fund's liability
  - The extent and timing of available reinsurance recoveries may be subject to significant uncertainties
  - Alternative strategies for the liquidation of assets of the insolvent company that affect the timing and level of assessments

- Certain liabilities of the insolvent insurer may be particularly difficult to estimate (for example, asbestos or environmental liabilities)

Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be reevaluated regularly during the assessment process. For some ranges, there may be amounts that appear to be better estimates than any other within the range. If this is the case, the liability recorded should be based on the best estimate within the range. For ranges in which there is no such best estimate, the liability that should be recorded should be based on the amount representing the minimum amount in the range.

## Application of Guidance

- 20.** A discussion on applying the conclusions in paragraphs 10 through 19 to the methods used to address guaranty-fund assessments and other insurance-related assessments (as described in paragraphs 4 and 7) follows.
- a.** *Retrospective-premium-based guaranty-fund assessments.* An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.
  - b.** *Prospective-premium-based guaranty-fund assessments.* The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based.<sup>7</sup> Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency.

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7. For example, multiple-year contracts under which an insurance enterprise has no discretion to avoid writing future premiums.

In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments should recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

- c.** *Prefunded-premium-based guaranty-fund assessments.* A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related premiums are written.
- d.** *Other premium-based assessments.* Other premium-based assessments, as described in paragraph 6, would be accounted for in the same manner as prefunded-premium-based guaranty-fund assessments.
- e.** *Loss-based assessments.* An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related loss is incurred.

## **Present Value**

- 21.** Current practice in the insurance industry is to allow, but not require (with limited exceptions, such as pensions and

postretirement benefits), the discounting of liabilities to reflect the time value of money when the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for a particular liability. Similarly, for assessments that meet those criteria, the liability may be recorded at its present value by discounting the estimated future cash flows at an appropriate interest rate.

## **Reporting Assets for Premium Tax Offsets and Policy Surcharges**

- 22.** When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset should be recognized for that recovery in an amount that is determined based on current laws and projections of future premium collections or policy surcharges from **in-force policies**. In determining the asset to be recorded, in-force policies do not include expected renewals of short-duration contracts but do include assumptions as to persistency rates for long-duration contracts. The recognition of such assets related to prospective-premium-based assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SOP requires an entity to recognize a liability for prospective-premium-based assessments as the premium is written or obligated to be written by the entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments should similarly be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.
- 23.** For retrospective-premium-based assessments, this SOP requires an entity to recognize a liability for such assessments at the time the insolvency has occurred. Accordingly, to the extent that it is probable that paid or accrued assessments will result in a recoverable amount in a future period from business currently in force considering appropriate persistency rates, an asset should be recognized at the time the liability is recorded.



- 24.** In all cases, the asset shall be subject to a valuation allowance to reflect any portion of the asset that is no longer probable of realization. Considering expected future premiums other than on in-force policies in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.
- 25.** The time value of money need not be considered in the determination of the recorded amount of the potential recovery if the liability is not discounted. In instances in which the recovery period for the asset is substantially longer than the payout period for the liability, it may be appropriate to record the asset on a discounted basis regardless of whether the liability is discounted.
- 26.** The policy surcharges referred to in this SOP are those surcharges that are intended to provide an opportunity for assessed entities to recover some or all of the amounts assessed over a period of time. In some instances, there may be policy surcharges that are required as a pass-through to the state or other regulatory bodies, and these surcharges should be accounted for in a manner such that amounts collected or receivable are not recorded as revenues and amounts due or paid are not expensed (meaning, similar to accounting for sales tax).

## **Disclosures**

- 27.** FASB Statement No. 5, FASB Interpretation No. 14, and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, address disclosures related to loss contingencies. That guidance is applicable to assessments covered by this SOP. Additionally, if amounts have been discounted, the entity should disclose in the financial statements the undiscounted amounts of the liability and any related asset for premium tax offsets or policy surcharges as well as the discount rate used. If amounts have not been discounted, the entity should disclose in the financial statements the amounts of the liability, any related asset for premium tax offsets or policy surcharges, the periods over which the assessments are expected to be paid,

and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

## **Effective Date and Transition**

- 28.** This SOP is effective for financial statements for fiscal years beginning after December 15, 1998. Early adoption is encouraged. Previously issued annual financial statements should not be restated. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods should be restated). Entities subject to assessments should report the effect of initially adopting this SOP in a manner similar to the cumulative effect of a change in accounting principle. (Refer to paragraph 20 of APB Opinion 20, *Accounting Changes*.)

The provisions of this Statement of Position  
need not be applied to immaterial items.

## **Basis for Conclusions**

- 29.** This section discusses considerations that were deemed significant by members of the AcSEC in reaching the conclusions in this SOP. It provides background information and includes reasons for accepting certain views and rejecting others.
- 30.** The authoritative financial reporting literature does not address explicitly accounting for guaranty-fund and other insurance-related assessments and related premium tax offsets and policy surcharges of entities subject to assessments. AcSEC considered the following pertinent literature in reaching the conclusions in this SOP:
- FASB Statement No. 5, *Accounting for Contingencies*
  - FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
  - FASB Statement No. 87, *Employers' Accounting for Pensions*

- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*
- AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*
- AICPA SOP 96-1, *Environmental Remediation Liabilities*
- Emerging Issues Task Force (EITF) Issue No. 87-22, *Prepayments to the Secondary Reserve of the FSLIC*
- EITF Issue No. 91-10, *Accounting for Special Assessments and Tax Increment Financing Entities*
- EITF Issue No. 92-13, *Accounting for Estimated Payments in Connection with the Coal Industry Retiree Health Benefit Act of 1992*
- EITF Issue No. 93-5, *Accounting for Environmental Liabilities*
- EITF Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*
- EITF Topic D-47, *Accounting for the Refund of Bank Insurance Funds and Savings Association Insurance Fund Premiums*
- FASB Concepts Statement No. 6, *Elements of Financial Statements*
- Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 62, *Discounting by Property/Casualty Insurance Companies*
- SEC SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*

## **Reporting Liabilities**

- 31.** FASB Statement No. 5, paragraph 8, requires the accrual of a liability when “a. Information available prior to issuance of the financial statements indicates that it is probable that

. . . a liability has been incurred at the date of the financial statements” and “b. The amount of loss can be reasonably estimated.” With respect to assessments, FASB Statement No. 5, paragraph 33, states, in part:

The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

- a. The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.

FASB Statement No. 5, paragraph 34, states, in part:

As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for . . . assessments whose underlying cause is an event or condition occurring after the date of financial statements . . . .

**32.** Therefore, for a liability to be recognized in the financial statements, the underlying cause must have occurred on or before the date of the financial statements. The SOP identifies the obligating event for each kind of assessment, which is the underlying cause.

**33.** In reaching the conclusions in this SOP concerning when to recognize liabilities for assessments, AcSEC considered the definition of liabilities in paragraph 35 of FASB Concepts Statement No. 6 and the concept of present obligation:

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [*Footnote references omitted.*]

**34.** To apply the definition of liabilities in paragraph 35 of FASB Concepts Statement No. 6 to assessments, AcSEC considered the underlying cause that creates a present obligation for entities subject to assessments to pay assessments. In order to have a present obligation, the entity

must have little or no discretion to avoid the future sacrifice, and the event that obligates the entity must have occurred no later than the date of the financial statements.

- 35.** AcSEC concluded that the fundamental differences in the assessment mechanisms justified identifying different events, depending on the kind of assessment, that would obligate an entity and require recognition of a liability.

## **Obligating Event**

- 36.** More than one event may need to occur before there is a cause for an assessment. AcSEC believes that only when all of the events required to give rise to a cause for action have occurred has the event underlying a liability occurred. AcSEC concluded that the insolvency is the initial event that will give rise to a cause for an assessment, either currently or at some point in the future. The insolvency may or may not also be the final event.
- 37.** If, through the operation of law or regulatory practice, the enterprise has at the time of an insolvency an unavoidable obligation (subject only to the actual imposition of the assessment) to pay for some portion of the insolvency, no further events are required for there to be an underlying cause of a liability. However, if at the moment of the insolvency the enterprise does not, through the operation of law or regulatory practice, have an unavoidable obligation (subject only to the actual imposition of the assessment), then another event is the final event underlying the obligation.

## **Assessments Based on Premiums**

- 38.** For assessments based on premiums written after the insolvency, AcSEC concluded that the writing of premiums on which a potential assessment is based generally should be considered the underlying cause of an entity's obligation to pay cash in the future.<sup>8</sup>

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8. As discussed in paragraph 13, some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if the insurance enterprise reduces premium writings in the future. For example, in certain states, an insurance enterprise may remain liable for assessments even though the insurance enterprise discontinues the writing of premiums. In this case, the underlying cause of the liability is not the writing of the premium, but the insolvency.

- 39.** In making its decision, AcSEC noted that entities generally have the option of reducing or eliminating their premium-writing activity, thereby reducing or eliminating their assessment. AcSEC was also influenced by the fact that entities subject to assessments that enter a new state or increase market share in a state will be required to pay assessments for insolvencies that occurred before they entered that state or increased their market share. The fact that such entities will have to pay assessments for insolvencies that occurred previously supports the conclusion that the writing of premiums is the underlying cause of the assessments.
- 40.** AcSEC believes that a number of analogies support the conclusions in this SOP. For example, in EITF Issue No. 93-6, a ceding enterprise would recognize a liability for obligatory retrospectively rated contracts only to the extent that it has an obligation to pay cash (or other consideration) to a reinsurer that would not have been required in the absence of experience under the contract. Furthermore, EITF Issue No. 93-6 specifically prohibits ceding companies from recognizing liabilities for amounts expected to be paid in the future that relate to prior catastrophe losses (for example, through increased costs of reinsurance) when no contractual obligation to make such payments exists. AcSEC believes that entities subject to assessments have no obligation to pay assessments unless the premiums on which the assessments are to be based are written.
- 41.** In EITF Issue No. 92-13, the EITF reached a consensus that allowed enterprises with operations in the coal industry to account for their obligations under the Coal Industry Retiree Health Benefit Act of 1992 (which created a fund to pay benefits related to certain coal-industry benefit trusts that were operating at deficits) as multiemployer pension plans. Guaranty funds are similar to multiemployer pension plans in that each insurance enterprise's payments to the fund are used to satisfy the general obligations of the fund and are not segregated for the benefit of any one enterprise.
- 42.** AcSEC also believes that accounting for claims-made insurance provides an appropriate analogy. In claims-made insurance, the insured event is the reporting, during the term of the policy or within a specified period following the

coverage period, to the insurer of a claim for a covered loss. For such policies, entities subject to assessments estimate a liability for unpaid claims based only on claims reported, despite the fact that other losses may have been incurred that eventually may result in claims to that insurance enterprise. The agreement between the insurer and the insured is that the insurance enterprise is not obligated to cover those unreported losses, unless that insurance enterprise is providing coverage under a claims-made policy when the claim is made. Similarly, the substance of the arrangement for most premium-based assessment mechanisms is that an insurance enterprise is obligated to pay assessments only if the premiums on which the assessments are to be based are written.

### ***Assessments Based on Losses***

- 43.** For loss-based assessments, AcSEC concluded that the event underlying an insurance enterprise's obligation to pay the assessment is the incurrence of losses on which the assessments are expected to be based (regardless of whether the assessment is based on paid or incurred losses). AcSEC believes that entities subject to assessments have little or no discretion to avoid the future sacrifice once the losses on which the assessments are expected to be based have been incurred. Unlike premium-based assessments, in which the insurance enterprise has the discretion to write or not to write premiums (even if it is unlikely that the insurance enterprise will not write such future premiums), an insurance enterprise is obligated to pay the loss-based assessments once those losses are incurred.
- 44.** AcSEC considered whether it is appropriate to recognize a liability for assessments for administrative-type state funds as the losses on which the assessments are based are incurred by entities. Some have indicated that it is not appropriate to accrue a liability for operating costs of a state fund that have not yet been incurred by the state fund. AcSEC concluded that loss-based assessments for administrative-type funds should be accrued as losses of an entity occur if it is probable that a related assessment will be made. AcSEC believes this is similar to the accounting in FASB Statement No. 60, whereby liabilities for claim adjustment

expenses that relate to unpaid claims are accrued before the costs are incurred. Once the losses are incurred, insurance enterprises have little or no discretion to avoid paying the assessment.

## **Probability of Assessment**

- 45.** Although entities subject to assessments may be able to determine that future assessments are probable for some period before a formal determination of insolvency occurs, AcSEC concluded that assessments should not be considered probable until a formal determination of insolvency occurs, unless the assessments are being made by a pre-funded guaranty fund. AcSEC believes that the formal determination date is the most objectively determinable measurement date and that requiring its use will foster comparability in reporting. Furthermore, AcSEC believes mere speculation about an insurance enterprise's insolvency should not be considered an accounting event.

## **Present Value**

- 46.** AcSEC believes that recognizing assessment liabilities at their present value provides the most representative measure of the economic substance of the situation. Nevertheless, AcSEC declined to mandate present-value-based measurements while the FASB is still considering the role of present-value-based measurements in financial reporting. For the same reason, this SOP provides no detailed guidance on present-value methodologies and discount rates.

## **Premium Tax Offsets, Policy Surcharges, and Future Rate Making**

- 47.** AcSEC believes that, when it is probable that paid or accrued assessments will result in premium tax offsets or policy surcharges, the recognition of an asset is appropriate based on current laws and projections of future premium collections from in-force policies. No asset should be recognized related to expected new business or renewal of in-force short-duration contracts. In making this determination, AcSEC considered the characteristics of an asset in para-



graph 26 of FASB Concepts Statement No. 6, which states, in part:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

- 48.** Premium tax offsets, policy surcharges, and the incorporation of assessment costs in future premium rate structures have a similar purpose, that is, to allow entities subject to assessments to recoup some portion of assessment costs. Nevertheless, AcSEC concluded that the ability to include assessments in future premium rate structures should be treated differently from premium tax offsets and policy surcharges. Premium tax offsets and policy surcharges are statutorily provided and generally are not dependent on the ability or intent of an insurance enterprise to take any action. In contrast, there can be no assurance that the future competitive or regulatory environment will allow an insurance enterprise to include assessments in future premium rate structures in such a manner as to result in a recovery of costs. Thus, AcSEC concluded that the statutory ability to include assessment costs in future premium structures should not result in asset recognition and should not be used to reduce current assessment costs.
- 49.** To the extent that paid or accrued guaranty-fund costs are expected to result in premium tax offsets or policy surcharges, AcSEC believes that it is appropriate to consider the recognition of such recoveries as assets. AcSEC believes that the amount of the asset should be limited to expected future premiums related to policies in force at the measurement date. AcSEC considered whether it is appropriate to consider all expected future premiums in establishing such recoveries and concluded that this approach would introduce an inconsistency with AcSEC's decision not to recognize a liability for guaranty-fund and similar assessments that are based on future premiums. Therefore, AcSEC determined that considering all expected future

premiums in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate.

50. AcSEC also considered whether there was an inappropriate inconsistency between requiring the use of persistency assumptions in asset recognition and not for liability recognition in prospective-premium-based assessments (for example, for multiple-year contracts). AcSEC concluded that this treatment was appropriate due to the limited number of instances in which persistency assumptions would be applicable for liability measurement.

### ***Prefunded-Premium-Based Assessments***

51. For prefunded-premium-based assessments, as long as such funds do not provide, either by statute or practice, for a return of excess assessments, no asset should be recorded.

### **Transition**

52. AcSEC decided to prohibit the retroactive application of this SOP. AcSEC recognizes the benefits of comparative financial statements but believes that the necessary information for entities subject to assessments to create for prior periods the necessary estimates of liabilities for future assessments and of the timing and amounts of cash flows would not be readily available.

## **APPENDIX A**

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# **Illustration of Computation of Assessment Liabilities**

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### **Example 1—Prospective-Premium-Based Assessment<sup>1</sup>**

#### ***Scenario***

As a result of insolvencies in prior years, ABC Property & Liability Insurance Company (ABC) expects to be assessed in the future by the guaranty fund in a state where it writes premiums. Any such assessments will be limited to 2 percent of premium writings in the prior year and are recoverable through premium tax offsets on a ratable basis over the five-year period following the year of each assessment.

Although it does not expect to do so, ABC is free to cease writing the lines of business that are subject to the guaranty-fund assessments.

As of December 31, 19X0, ABC has neither paid nor received a notice of an assessment related to the insolvencies. Based on communications from the state guaranty association, ABC expects to receive an assessment in 19X1, which is allocated among entities based on 19X0 market share, for at least 1 percent of 19X0 premiums that are subject to the assessment. A best estimate cannot be determined, and no amount within the range of estimates (meaning, from 1 to 2 percent of 19X0 premiums) is a better estimate than any other amount, therefore the minimum amount in the range should be accrued.

#### ***Result***

As of December 31, 19X0, ABC should recognize a liability equal to 1 percent of the premiums written in 19X0 that are subject to the assessment. No additional liability should be recognized, and no asset related to the premium tax offset should be recognized.

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1. This kind of assessment is considered prospective since the assessment relates to premium written subsequent to the insolvency.

Disclosure of the loss contingency of up to an additional 1 percent of the subject premiums should be considered.

## **Discussion**

ABC would recognize a liability only for those future assessments it is obligated to pay as a result of the premiums written. Because ABC is not obligated to write any future premiums, its liability is limited to that related to premiums written in 19X0. Because no amount within the range of estimates is a better estimate than any other amount, the minimum amount in the range is accrued. Further, because the premium tax offset is realizable only on business that will be written in the future (that is, 19X2 and subsequent years), no asset or receivable is recognized as of December 31, 19X0.

## **Example 2—Retrospective-Premium-Based Assessment**

### **Scenario**

As a result of an insolvency that occurred during 19X0, DEF Life and Health Insurance Company (DEF) expects to be assessed in the future by the guaranty fund in a state where it has written business. Any such assessment will be based on DEF's average market share, determined based on premiums that are subject to the assessment for the three years prior to the insolvency, and limited to 2 percent of the average annual subject premiums for the three years prior to the insolvency. Further, such assessments are recoverable through premium tax offsets over the five-year period following the year of payment for each assessment.

As of December 31, 19X0, DEF has not paid or received a notice of an assessment related to the insolvency. Based on initial input from the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and experience with other insolvencies, DEF assumes that the first assessment will not be made until 19X3 and that it will take three to five annual assessments in order for the guaranty fund to be able to meet its obligations. Based on the estimated nationwide cost of the insolvency and the distribution of the insolvent company's business, DEF estimates that its assessment will be at least 1 percent of the average annual premiums that are subject to the assessment. No amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for three to five years) is a better estimate than any other amount, therefore the minimum amount in the range should be accrued.

## **Result**

As of December 31, 19X0, DEF should recognize a liability for three years of assessments at 1 percent of the average annual premiums that are subject to the assessment (that is, the assessments expected in 19X3, 19X4, and 19X5). Disclosure of the loss contingency for additional assessments (meaning, in 19X6 and 19X7) or assessment of greater than 1 percent of the average annual premiums that are subject to the assessment should be considered. An asset related to premium tax offsets that are available on accrued assessments would be recorded provided there were sufficient premium taxes based on business in force at December 31, 19X0 (with assumed levels of policy retention) to allow realization of the asset.

The resulting recognized liability and asset are as follows (shown on both a discounted and undiscounted basis, based on paragraphs 21 and 25, discounting is optional), assuming average annual subject premiums of \$100,000 for the three years prior to the insolvency.

## **Discussion**

DEF would record a liability for all future assessments related to the insolvency. Because no amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for three to five years) is a better estimate than any other amount, the minimum amount in the range (meaning, 1 percent per year for three years of assessments) is accrued.

Since it is assumed that based upon the anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset, the premium tax offset is recorded.

## **Example 3—Loss-Based Assessment**

### **Scenario**

GHI Industrial Company (GHI) is self-insured for workers' compensation and therefore participates in the second injury fund in the state where it conducts operations. GHI is entitled to recover from the fund for some or all of the indemnity claims for previously injured workers. GHI is also subject to annual assessments (maximum of 1 percent per year) on indemnity claims paid each year.

Assessment rates have been climbing steadily, from 0.6 percent five years ago to 0.75 percent in 19X0.

Schedule of Assessments and Premium Tax Offsets

Assessments	Recorded at										Cash Payments									
	12/31/19X0	19X1	19X2	19X3	19X4	19X5	19X6	19X7	19X8	19X9	20X0	19X3	19X4	19X5	19X6	19X7	19X8	19X9	20X0	
19X3 Assessment				1,000																
19X4 Assessment					1,000															
19X5 Assessment										1,000										
Total	3,000			1,000	1,000	1,000														
Premium Tax Offset																				
19X3 Assessment (1)					200	200	200	200	200							200				
19X4 Assessment (1)						200	200	200	200	200	200					200	200			
19X5 Assessment (1)											200	200	200	200	200	200	200	200	200	
Total	3,000				200	400	400	400	600	600	600	600	600	600	600	400	400	400	200	
Present value of assessments at 12/31/19X0 (2)	2,470																			
Present value of Premium Tax Offset at 12/31/19X0 (2)	2,139																			

(1) Assumes that, based upon anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset.

(2) Discounted at 5 percent, assuming all assessments are paid and offsets realized at the end of each year.

## **Results**

As of December 31, 19X0, GHI should have an assessment liability recognized for 0.75 percent of its liability for the payment of future indemnity claims, unless there was information to support the assessment rate being reduced or the assessments being eliminated in the future. Disclosure of the loss contingency of up to an additional 0.25 percent of the liability for the payment of future indemnity claims should be considered. See the chart on the facing page.

## **Discussion**

GHI would recognize a liability based on the current assessment rate, unless there was clear evidence that the rate would change. The liability would be based on the entire liability base that was subject to the assessment.

## **APPENDIX B**

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### **Discussion of Comments Received on the Exposure Draft**

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An exposure draft of a proposed Statement of Position (SOP), *Accounting by Insurance and Other Enterprises for Guaranty-Fund and Certain Other Insurance-Related Assessments*, was issued for public comment on December 5, 1996, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Twenty-four comment letters were received in response on the exposure draft. The most significant and pervasive comments received were in the following four areas:

1. Reporting assets and policy surcharges
2. Estimation of the assessment liability
3. Accounting for prospective-premium-based assessments
4. Scope

#### **Reporting Assets and Policy Surcharges**

The guidance in the exposure draft on reporting assets and policy surcharges caused some confusion. Several respondents requested clarification about the kind of entity that would recognize assets for premium tax offsets and policy surcharges. AcSEC clarified the guidance to explain how an asset should be accounted for when it is probable that a paid or accrued assessment will result in an amount that is expected to be recoverable.

#### **Estimation of the Assessment Liability**

Several respondents commented that they do not believe a liability can be reasonably estimated by an entity for guaranty-fund assessments because the entity will not have the necessary information to estimate the amount of loss. These respondents commented that a determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment because of such fac-



tors as alternative strategies for the liquidation of assets of the insolvent company that affect the timing and level of assessments and certain liabilities of the insolvent insurer may be particularly difficult to estimate (for example, asbestos or environmental liabilities). AcSEC believes that, although it may be difficult to calculate a point estimate in certain circumstances (see paragraph 19), in the majority of cases, enough information is available to calculate a range of estimates. Further, in the case of prospective-premium-based assessments, the liability to be recorded is related only to premiums written or obligated to be written, rather than to all expected future premiums.

## **Accounting for Prospective-Premium-Based Assessments**

The exposure draft contained an alternative view on accounting for prospective-premium-based assessments, which discussed that a minority of AcSEC believed that the insolvency should be considered the underlying cause of an entity's obligation to pay future assessments, irrespective of the basis used to determine the amount due from each insurance enterprise subject to the assessment. The majority of respondents did not support this minority view. AcSEC continues to believe that the writing of the premium on which potential assessments are expected to be based is the underlying cause of an entity's obligation to pay cash in the future.

## **Scope**

Because entities other than insurance enterprises are assessed insurance-related assessments, the scope of the exposure draft included all reporting entities. Although some noninsurance entities requested to be excluded from the scope, most of the respondents believe that both insurance enterprises and noninsurance enterprises would have sufficient information to recognize a liability for the assessments covered in the SOP.

# GLOSSARY

**Incurred losses.** Losses paid or unpaid for which the company has become liable during a period.

**In-force policies.** Policies effective before a specified date that have not yet expired or been canceled.

**Involuntary pools.** A residual market mechanism for insureds who cannot obtain insurance in the voluntary market.

**Life, annuity, and health insurance enterprise.** An enterprise that may issue annuity, endowment, and accident and health insurance contracts as well as life insurance contracts. Life and health insurance enterprises may be either stock or mutual organizations.

**Obligated to write.** If an entity has no discretion to cancel a policy because of legal obligation under state statute or contract terms, or regulatory practice and is required to offer or issue insurance policies for a period in the future.

**Premium tax offsets.** Offsets against premium taxes levied on insurance companies by states.

**Premiums written.** The premiums on all policies a company has issued in a period.

**Property and casualty insurance enterprise.** An enterprise that issues insurance contracts providing protection against either (1) damage to or loss of property caused by various perils, such as fire and theft or (2) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance enterprises may be either stock or mutual organizations.

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