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Issues Paper

Accounting for Mortgage Guaranty Insurance

Prepared by the
Insurance Companies Committee
American Institute of Certified Public Accountants

830179

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File Ref. No. 3100
D R A F T

Issues Paper

Accounting for Mortgage Guaranty Insurance

Introduction

1. When the AICPA Accounting Standards Division issued statement of position (SOP) 78-6 on Accounting for Property and Liability Insurance Companies, it stated in paragraph 3 that the sections in the SOP relating to premium revenue recognition, deferred acquisition costs, premium deficiencies, losses, and loss adjustment expenses did not apply to mortgage guaranty insurance and that the AICPA Insurance Companies Committee was considering mortgage guaranty insurance separately. Mortgage guaranty insurance was excluded from SOP 78-6 because it is significantly different from other forms of property and liability insurance in that the coverage is long-term in nature and most policies do not have level annual premiums. This issues paper discusses all issues relating to mortgage guaranty insurance with the exception of (a) whether loss reserves should be discounted and (b) whether anticipated investment income should be considered in computing premium deficiencies. These issues, as they relate to all insurance companies, are being considered in a separate issues paper.

2. The sections of SOP 78-6 on (a) valuation of investments and recognition of related realized and unrealized gains or losses and (b) real estate apply to mortgage guaranty insurance. Accordingly, these sections are reproduced in appendix A.

3. The interests of policyholders, lenders, and the public in the financial integrity of mortgage guaranty insurance companies make it important that the solvency of these companies be continuously demonstrated to regulatory authorities. Consideration of these interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by the insurance regulatory authorities (statutory accounting practices).[1] Federal income taxation of mortgage guaranty insurance companies is also based primarily on statutory accounting practices. The use of generally accepted accounting principles for financial reporting to shareholders and others should not be construed as an indication that generally accepted accounting principles should also be used in reporting to regulatory or taxing authorities.

Industry Background

4. The mortgage guaranty insurance industry consisted of fifteen companies with assets of approximately $1.3 billion, premium revenue of approximately $300 million and $88 billion of insurance in force at the end of 1978. The industry began in 1956 when the first private mortgage insurer obtained approval from the State of Wisconsin to guarantee lenders against default by mortgagors on one-to-four family residential dwellings. Previously, only the Federal Housing Administration (FHA) and Veterans Administration (VA) were authorized to issue mortgage insurance policies. From this beginning, the industry has expanded to

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1. Statutory accounting practices are practices that have been prescribed by statute, regulation, or rule or have been permitted by specific approval or acceptance.

a nationwide business operating in all 50 states, the District of Columbia, the Virgin Islands and several United States possessions.

5. Mortgage guaranty insurance protects lenders against non-payment by the mortgagor. Although coverage can range from as little as 2% to as much as 100% of the outstanding loan amount, most policies cover 10% to 30% of the loan amount and are written on first mortgage loans that represent a high percentage of the appraised or sales value (generally 80% to 95%). Normally, the mortgage loan would not have been granted without guaranty insurance.

6. If there is a loss on a mortgage loan, the insurance company will reimburse the lender the percentage of the loss specified in the policy. At the insurance company's option, it can pay off the entire loan and take title to the property.

7. Most insurance policies are purchased by savings and loan associations, savings banks, commercial banks, and mortgage bankers. Other purchasers include insurance companies and credit unions. The industry has grown to the point where it presently insures more loans than the FHA and VA combined.

8. Mortgage Guaranty policies presently have three forms of premium payment: 1) a single premium which provides coverage for periods ranging from 4 to 15 years with provision for subsequent renewals at the discretion of the lender, 2) annual premiums with a higher first year premium and lower renewal premiums and 3) level annual premiums. Annual premium policies are guaranteed renewable at fixed rates. At present, most policies are issued on the annual premium basis with higher first-year premiums and lower renewal premiums. The single-premium policy accounts for less than 10% of the business and the level-annual premium plan is relatively new.

9. Mortgage guaranty companies employ sales representatives who are compensated on a combination of salary and commissions, with commissions generally the higher portion. Commissions are paid on both new and renewal premiums. Some companies also pay bonuses to the sales representatives if their premium volume exceeds certain levels.

PREMIUM REVENUE RECOGNITION

Discussion

10. A mortgage guaranty insurance policy insures the lender up to a specified amount in the event of a loss resulting from the borrower defaulting on his mortgage payments. Single-premium policies are issued for a specified period of time and annual-premium policies are guaranteed renewable at fixed rates. Most

annual-premium policies have a first-year premium that is substantially higher than renewal premiums, which are relatively level. However, some annual-premium policies have level premiums throughout the life of the policy; in which case, the policyholder may be required to renew the policy for a specified minimum number of years. Generally, premiums are subject to a refund if the policyholder wishes to terminate coverage before the "paid to" date.

11. As previously stated, mortgage guaranty insurance is significantly different from other forms of property and liability insurance because a) the coverage is long-term in nature (non-cancellable policies) and b) the first-year premium on most annual-pay policies is substantially higher than renewal premiums. Although the likelihood of a loss on a mortgage guaranty insurance policy exists throughout the life of the policy, industry studies have generally shown that losses are relatively low during the first 18 months and increase significantly thereafter, through the fourth year and then decline again. Single premiums are received when the policy is issued and annual premiums are either received with a significantly higher first-year premium or on a level basis throughout the life of the policy. Accordingly, the timing of premium receipts does not follow the loss payment pattern. Significantly higher first-year premiums are generally two to four times more than renewal premiums and are intended to cover acquisition costs, the high risk of loss on low down

payment mortgages, and additional coverage selected by the lender.

Present Practices

12. Practice varies regarding the method of recognizing premium revenue in conformity with generally accepted accounting principles. For single-premium policies, most companies recognize revenue over the life of the policy in a manner that approximates the historical incidence of loss. This method attempts to match premiums with the anticipated incidence of loss.

13. For annual-premium policies, two primary revenue recognition methods are presently used:

a. Level and non-level premiums are earned on a pro rata basis over the period covered by the premium. (This is the predominate method.)

b. Premiums are earned on a pro rata basis over the period covered by the premium, except that on non-level premium policies, that portion of the first-year premium which covers the higher risk of loss on low down payment mortgages is deferred and amortized to income over the expected period losses will be incurred (approximately 7 to 10 years) on a 1) declining, 2) straight line, or 3) historical incidence of loss basis.

Views on Present Practices

14. Some believe that the revenue recognition method for single-premium policies discussed in paragraph 12 is not only

appropriate for those policies, but should also be applied to annual-premium policies because it attempts to match total revenue (first-year and renewal premiums) with the anticipated incidence of loss. They believe that total anticipated premiums to be received over the life of the policies, based on historical cancellation rates for annual-pay policies, should be recognized as revenue over the expected period that losses will be incurred in relation to the expected incidence of loss. Under this method, profits would be a level percentage of premiums earned before considering the effects of variances between actual and anticipated experience.

15. However, because of the higher incidence of loss in the second through fourth policy year, this method generally produces a theoretical receivable from policyholders (negative unearned premium) sometime during the life of the policies because cumulative premiums earned will exceed cumulative premiums collected at that particular time. Some believe it is inappropriate to recognize revenue that is not yet due. They believe that premiums earned on a cumulative basis should never exceed total premiums collected. Others believe that collectibility is reasonably assured based on historical experience and therefore it is appropriate to recognize such revenue.

16. Some believe that premiums on annual-premium policies should be recognized as earned on a pro rata basis over the period covered by the premiums. Those who support this method do

not believe that any portion of the additional first-year premium on non-level premium policies should be deferred beyond the first year since such premiums are not refundable after the first year.

17. Still others believe that the portion of the additional first-year premium on non level premium policies that covers the higher risk on low down payment mortgages should be deferred and amortized over the expected life of the policies.

18. Others believe that it is inappropriate to recognize revenue from single and annual-premium policies differently. They believe that revenue should be recognized as the service is provided in proportion to the coverage. Coverage is defined as that portion of the mortgage loan balance that is covered by insurance. On this basis, an equal amount of premium revenue would be recognized in each policy year assuming that the amount of coverage is relatively level. If there is a significant decline in the loan balance during the policy term, revenue would be recognized on a declining basis consistent with the decrease in coverage. (On a typical 30-year residential mortage loan, the principal balance is reduced only 8% in the first 10 years, which should not be considered a significant decline.)

Issue 1: How should premiums from single and annual-premium policies be earned?

* *

Advisory Conclusion

19. Single premiums should be earned on a pro rata basis throughout the policy term, or on a declining basis if the amount of coverage significantly declines during the policy term. Annual premiums should be earned on the same basis. Level annual premiums should be earned on a pro rata basis over the policy term (usually one year). Additional first-year premiums on non-level policies, that is, the difference between first-year and level renewal premiums, should be deferred and amortized to income over the anticipated premium-paying period of the policies in relation to total anticipated premium receipts excluding the additional first-year premiums. If the dollar amount of coverage significantly declines during the anticipated premium-paying period, the additional first-year premium should be amortized to income in relation to anticipated coverage. If the initial renewal premium rate is higher than subsequent renewal premium rates, the excess premiums should be deferred and amortized to income over the remaining anticipated premium-paying period of the policies in the same manner as the additional first-year premiums (this does not apply to policies with reduced premiums in later years, such as the 10th year or later). Level renewal premiums and the portion of the first-year premium equal to the level renewal premium should be earned on a pro rata basis over

the policy term (generally one year). When significant differences between anticipated and actual renewal premiums occur, the predetermined amortization of additional first-year premiums should be adjusted to reflect actual experience.

20. See Appendix B for an illustration of the proposed method of accounting for non-level annual-premium policies.

ACQUISITION COSTS

Discussion

21. Statutory accounting practices require that all costs incurred in connection with acquiring business be charged to expense as incurred. Regulatory authorities have, however, permitted higher first-year premiums to cover such costs. Renewal acquisition costs generally are not material.

22. Acquisition costs are incurred in connection with acquiring business (new and renewal premiums). Such costs include salaries and commissions (or production bonuses) paid to sales representatives, salaries of employees involved in the underwriting and policy issue functions, and premium taxes. Costs incurred in connection with maintaining the policies and settling claims are not acquisition costs nor are general and administrative expenses. Certain costs, such as depreciation, collection expenses, and professional fees, that do not vary directly with and are not directly related to the production of business are not acquisition costs.

Present Practices

23. Practice varies regarding the method of expensing acquisition costs in conformity with generally accepted accounting principles. However, all methods currently used defer and amortize acquisition costs to expense over some period of time. In the predominate method, acquisition costs are deferred and amortized to expense as related written premiums are earned which, in most cases, is over a one year period (the policy term). In some cases, a portion of the excess first year premium is deferred beyond the policy term and in these cases a proportionate share of the acquisition costs is also deferred beyond the policy term.

24. Some mortgage guaranty insurance companies amortize acquisition costs over the anticipated premium-paying period of the related policies in relation to anticipated revenue.

Views on Present Practices

25. Some believe that acquisition costs that vary directly with and are directly related to the production of business should be deferred. Others believe that in addition to costs that vary directly, certain acquisition costs that vary indirectly and are directly related to the production of business also should be deferred. Such costs would include salaries of sales representatives and underwriters. Still others believe that all acquisition costs related to the production of business should be deferred.

26. Some believe that many acquisition costs are in the nature of period costs which should not be deferred.

27. Some believe that acquisition costs should be amortized over the same period as the related written premiums are earned. They believe that acquisition costs are properly matched against first-year premiums because the excess first-year premium covers such costs. To the extent that first-year premiums are deferred beyond one year, a proportionate share of the acquisition costs should also be deferred beyond one year.

28. Others believe that acquisition costs should be amortized over the anticipated premium-paying period of the related policies in relation to anticipated premium revenue. They believe that acquisition costs are incurred to obtain premiums for a period of years, similar to life insurance, and renewal premiums should bear a proportionate share of the expense.

Issue 2: What acquisition costs should be deferred and over what period should they be amortized?

* *

Advisory Conclusion

29. Acquisition costs that vary directly or indirectly with and are directly related to the production of business should be deferred. Costs should be analyzed to determine if they meet these criteria. Arbitrary percentage allocations of certain expense classifications should not be used.

30. Acquisition costs incurred in any period should be allocated to single and annual-premium policies. Costs allocated to single-premium policies should be deferred and amortized to expense as the related premiums are earned. Costs allocated to annual-premium policies should be further allocated between first-year and renewal premiums. Costs allocated to first-year premiums (whether level or non-level premium policies) should be deferred and amortized to expense over the anticipated premium-paying period of the related policies in relation to total anticipated premium revenue. Costs allocated to renewal premiums should be deferred and amortized to expense as the related renewal premiums are earned. When significant differences between anticipated and actual renewal premiums occur, the predetermined amortization of deferred acquisition costs should be adjusted to reflect actual experience.

31. This conclusion is consistent with the accounting for acquisition costs for other types of insurance.

32. See Appendixes B and C for illustrations of the proposed method of accounting for acquisition costs related to non-level premium policies (Appendix B) and level-premium policies (Appendix C).

PREMIUM DEFICIENCIES

Discussion

33. Premiums are expected to pay losses and expenses and to provide a margin of profit over the policy life. Accordingly, unearned premiums and estimated renewal premiums on existing policies should be adequate to recover deferred acquisition costs and pay for losses and loss adjustment expenses expected to be incurred during the remaining policy life. If anticipated losses and loss adjustment expenses, maintenence expenses (expenses attributable to maintaining the policies in force), and unamortized deferred acquisition costs exceed unearned premiums and estimated renewal premiums on existing policies, a provision for the anticipated premium deficiency is required by FASB Statement No. 5, Accounting for Contingencies, paragraph 96.

34. No conclusion has been reached regarding whether anticipated investment income should be considered in computing premium deficiencies. This issue will be discussed in a separate issues paper.

Present Practices

35. Mortgage guaranty insurance companies do not have any significant experience in accounting for premium deficiencies. However, other property and liability insurance companies generally determine premium deficiencies by reasonable groupings of business consistent with a company's manner of acquiring, servicing, and measuring the profitability of its business.

Views on Present Practices

36. Most believe that premium deficiencies should be recorded if warranted by the circumstances.

Issue 3: Should premium deficiencies be recorded? If so, how should they be determined?

* *

Advisory Conclusion

37. When anticipated losses and loss adjustment expenses, maintenance expenses and unamortized deferred acquisition costs exceed unearned premiums and estimated renewal premiums on existing policies, a provision for the anticipated premium deficiency should be provided. Premium deficiencies should be determined by reasonable groupings of business based on line of business or geographical area. Premium deficiencies should be recognized by writing off any unamortized deferred acquisition costs to the extent required. If the deficiencies are more than the unamortized deferred acquisition costs, a separate liability should be provided for the excess deficiency .

38. In addition, companies that consider anticipated investment income in computing premium deficiencies should disclose the fact in their financial statements, together with the effects on the financial statements.

LOSSES

Discussion

39. A mortgage guaranty insurance policy insures the lender up to a specified limit in the event of a loss resulting from non-payment of a mortgage loan. A default (loan delinquency) by a borrower is the first evidence that a loss may occur. Policies generally require that lenders notify the insurance company after a borrower has failed to make an installment payment. Some policies only require notification after three or four installments are missed. Subsequently, the lender will make monthly reports on the status of defaults. Following the initial default, a borrower may pay all past due amounts (that is, the default is "cured"), the past due amounts remain constant as further payments are made, or the loan may go into foreclosure. A loan, once cured, may again become delinquent, in which case it is considered a new delinquency. Most reported defaults are eventually cured by the borrower. Even after formal foreclosure proceedings are instituted, a borrower often takes action to cure the default.

40. A claim consists of the unpaid principal balance, accrued interest, and certain expenses of the lender. The insurance company usually has the option of a) paying a percentage of the claim, generally ranging from 10% to 30% as specified in the policy, or b) paying the full amount of the claim and taking title to the property. Some policies require the insurance company to pay the full loss, however, these policies generally have aggregate loss limits.

41. No conclusion has been reached regarding whether loss

reserves should be discounted, that is, whether the time value of money should be considered in determining loss reserves. This issue will be discussed in a separate issues paper.

Present Practices

42. Some mortgage guaranty insurance companies record losses as of the initial default date based on the projected number of defaults that will eventually result in a loss based on historical "cure" ratios modified for current trends and the estimated ultimate claim cost based on historical experience. Loss reserves include estimates for defaults that have occurred but have not yet been reported to the company. Loss reserves are also maintained for defaults in foreclosure and claims presented but not yet paid. Changes in loss estimates resulting from the continuous review process and differences between estimates and ultimate payments are charged to expense as the estimates are changed.

43. Some companies do not record losses until 60 or 90 days after the initial default.

44. Still others record losses on loans presently not in default based on historical claim experience.

Views on Present Practices

45. Some believe that losses should be recognized as of the initial default date. Although only a small number of defaults actually result in a loss, they believe that the losses are "incurred" as of the initial default date. To record losses on

this basis, the percentage of defaults that will eventually result in a loss and the amount of the loss will have to be estimated based on historical experience.

46. Others believe that losses should not be recognized until the borrower's payments become 60 to 90 days past due since very few defaults of a lesser time eventually result in a loss.

47. Others believe that losses should be accrued only at the time of foreclosure when a loss is imminent. They believe that accruing losses before foreclosure is unrealistic since most defaults do not result in a loss.

48. Still others believe that claims should be accrued ratably over the premium-paying period of the policies in a manner similar to the method of accounting for claims on long-term noncancellable accident and health insurance policies. Under this method, as the policies are issued, estimates would be made of claims that will ultimately be paid and premiums that will ultimately be received on such policies. Based on this relationship, claims would then be accrued in relation to premiums earned. If significant differences between anticipated and actual claims or renewal premiums occur, the accrual of claims would be adjusted to reflect actual experience.

49. Still others believe that claims should be accrued ratably over the premium-paying period of the policies giving consideration to the time value of money (present value basis).

Issue 4: When should losses be accrued?

* *

Advisory Conslusion

50. Losses should be accrued as of the initial default date, however, if a company can demonstrate that another date is more appropriate, such as 60 or 90 days after the initial default, losses may be accrued as of that date.

51. In addition, companies that discount loss or loss adjustment expense reserves (see paragraphs 56 through 59) should disclose that fact in their financial statements, together with the effects on the financial statements.

PROPERTY ACQUIRED IN SETTLING CLAIMS

Discussion

52. Mortgage guaranty insurance companies may acquire property in settling claims, which is generally accounted for at the amount of cash, or its equivalent, expected to be derived from the sale of the property, net of costs such as maintenance and selling expenses required to be incurred prior to sale.

Present Practices

53. In some instances, property acquired in settling claims is valued at current market value and, in other instances, it is valued at current market value less estimated maintenance and selling expenses.

Views on Present Practices

54. Most believe that property acquired in settling claims should be valued as described in paragraph 52.

Issue 5: How should property acquired in settling claims be valued?

* *

Advisory Conclusion

55. Property acquired in settling claims should be accounted for at the amount of cash, or its equivalent, expected to be derived from the sale of the property, net of costs such as maintenance and selling expenses required to be incurred prior to sale. Such property should be separately presented in the balance sheet and should not be classified as an investment. Subsequent reductions in the carrying amount, and realized gains and losses on the sale of such property, should be charged or credited to claims incurred.

LOSS ADJUSTMENT EXPENSES

Discussion

56. Statutory accounting practices require that all costs associated with the settlement of losses should be accrued in the period that the related losses are incurred. Those costs include

amounts paid for outside services and direct, indirect, and fixed internal costs associated with the settlement of claims and disposition of property acquired in settling claims. Certain of these expenses, such as appraisers' fees, can be directly associated with specific claims. Other settlement expenses, such as internal claims department expenses, cannot be associated with specific claims but can only be related in general to incurred claims.

Present Practices

57. The statutory accounting practice has been generally accepted by mortgage guaranty insurance companies.

Views on Present Practices

58. Most believe that the statutory accounting practice is appropriate for reporting loss adjustment expenses under generally accepted accounting principles.

Issue 6: When should loss adjustment expenses be accrued?

* *

Advisory Conclusion

59. All expenses expected to be incurred in connection with the settlement of claims should be accrued at the time claims are accrued.

TRANSITION

Advisory Conslusions

60. The advisory conclusions in this issues paper should be applied to financial statements of mortgage guaranty insurance companies issued for annual and interim periods beginning after (one year after approval by FASB). The advisory conclusions should be applied retroactively, and financial statements presented for prior periods should be restated. Adjustments to prior periods should be based on anticipated experience that would have been reasonable at the time the original financial statements were issued. The individual effects of changing to the accounting principles in this issues paper should be disclosed in the financial statements.

Appendix A

(Excerpt from the AICPA statement of position 78-6 on Accounting for Property and Liability Insurance Companies)

Valuation of Investments and Recognition of Related Realized and Unrealized Gains or Losses

Discussion

51. Under statutory accounting practices, investments in common and preferred stocks are carried at market value, bonds are generally carried at amortized cost, mortgages are generally carried at unpaid principal, and real estate generally is carried at depreciated cost. Realized investment gains or losses are credited or charged to income. Changes in the carrying amount of investments representing unrealized appreciation or depreciation are charged or credited to stockholders' (members') equity.

52. The statutory method of accounting for investments is supported by the following reasoning—

a. Carrying bonds whose value has not been permanently impaired at amortized cost is appropriate since a company that has the ability and intent to hold the investments to maturity will be able to realize face amount. Market values that reflect periodic changes in prevailing interest rates are irrelevant in valuing bonds that are expected to be held to maturity.

b. Carrying common and preferred stocks at market is appropriate because a company has no assurance that it will receive more or less than the current market value.

c. Including realized investment gains and losses in net income is appropriate since it is based on the realization principle. Periodic fluctuations in market value are appropriately recognized in valuing equity investments but should not be included in net income because the fluctuations do not meet the realization principle.

53. The guide* endorses the statutory basis for valuing investments. However, it suggests that realized and unrealized investment gains or losses should be combined in a separate financial statement. Those who support the separate statement approach believe that valuation of investments under the statutory method is appropriate for the reasons stated above. However, they advocate that changes in the value of investments, whether realized or unrealized, should be presented in a separate financial statement as one combined amount. They believe that the treatment is the most meaningful since the realization of a gain or loss has an offsetting effect on the related unrealized gain or loss. Because of the materiality of the amounts and the significant fluctuations that occur, realized and unrealized gains or losses should not be included in the determination of net income because they feel they would make net income meaningless.

* The AICPA industry audit guide, Audits of Fire and Casualty Insurance Companies

54. Some believe that the results of realized gains and losses should be reported as an integral part of an insurance company's results of operations because an investor's appraisal of an insurance company's performance should include the results of realized gains and losses over a period of years.

55. FASB Statement no. 12, *Accounting for Certain Marketable Securities*, discusses the accounting treatment to be followed by specialized industries, such as property and liability insurance companies, with respect to investments in common and preferred stocks.

Conclusions

56. Bonds should be carried at amortized cost if the company has both the ability and intent to hold the bonds until maturity and there is no decline in the market value of the bond other than a temporary decline. In those rare instances in which a company is a trader in bonds and does not intend to hold the bonds until maturity, the bonds should be carried at market; temporary fluctuations in the market value of the bonds should be recognized as unrealized gains or losses.

57. Common and nonredeemable preferred stocks should be carried at market. Preferred stocks that by their terms must be redeemed by the issuing company should be carried at amortized cost if the company has both the ability and intention to hold the stocks until redemption and there is no decline in the market value of the stocks other than a temporary decline.

58. Mortgages should be accounted for at unpaid principal unless collectibility is uncertain. Real estate investments should be accounted for at depreciated cost unless there is an impairment in value. Amortization, depreciation, and other related charges or credits should be charged or credited to investment income. Charges and credits to valuation accounts should be included in realized gains and losses.

59. Realized gains and losses on all assets held for investment (including, but not limited to, stocks, bonds, mortgage loans, real estate, joint ventures, and subsidiaries held for investment) should be included in the statement of income, below operating income and net of applicable income taxes. Realized gains and losses on the sale of other assets, such as property used in the business and operating subsidiaries, should be included in the statement of income before applicable income taxes. Unrealized investment gains and losses should be recognized in stockholders' (members') equity net of applicable income taxes.

60. If a decline in the value of an investment in a security below its cost or amortized cost is other than temporary, the investment should be written down to its net realizable value, which becomes the new cost basis. The amount of the write-down should be accounted for as a realized loss. A recovery from the new cost basis should be recognized only at the sale, maturity, or other disposition of the asset, as a realized gain.

61. Valuation accounts should not be used for common stocks, preferred stocks, or publicly-traded bonds.*

Real Estate **

Discussion

62. Under statutory accounting practices, real estate is classified as an investment regardless of its use. For real estate used in operations, rent is included in investment income and is charged to the operating departments. The guide is silent on that subject, and the statutory accounting practice has gained general acceptance in the industry.

Conclusions

63. Real estate should be classified either as an investment or as property used in the business, based on its predominant use. Depreciation and other real estate operating expenses should be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rent expense should not be attributed to real estate used in the business.

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* This paragraph is not intended to preclude the accrual of losses from uncollectible receivables when both conditions in paragraph 8 of FASB Statement no. 5, Accounting for Contingencies, are met.

** This section does not include property acquired in settling claims (see paragraphs 35 through 37).

Appendix B

Illustration of Accounting for Nonlevel Premiums and Acquisition Costs

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
			Earned Premiums					Acquisition Costs Expensed			
Calendar Year	Projected Policies in Force (a)	Projected Premium Receipts (b)	Amortization of Additional First-Year Premiums(1)	Level First Year and Renewal Premiums	Total	Unearned Premiums (d)	Acquisition Costs Incurred (e)	Amortization of First-Year Acquisition Costs(2)	Level First-Year and renewal Acquisition Costs	Total	Deferred Acquisition Costs(f)
1979	100	$25,000(c)	$ 1,028	$ 6,250	$ 7,278	$17,722	$10,625	$ 822	$ 313	$ 1,135	$ 9,490
1980	96	11,900	2,007	12,200	14,207	15,415	595	1,605	610	2,215	7,870
1981	87	10,700	1,859	11,300	13,159	12,956	535	1,487	565	2,052	6,353
1982	74	9,100	1,629	9,900	11,529	10,527	455	1,303	495	1,798	5,010
1983	62	7,500	1,365	8,300	9,665	8,362	375	1,092	415	1,507	3,878
1984	55	6,600	1,159	7,050	8,209	6,753	330	928	352	1,280	2,929
1985	43	5,200	971	5,900	6,871	5,082	260	776	295	1,071	2,117
1986	33	4,000	756	4,600	5,356	3,726	200	605	230	835	1,482
1987	25	2,900	567	3,450	4,017	2,609	145	454	173	627	1,000
1988	18	2,100	411	2,500	2,911	1,798	105	329	125	454	651
1989-98	15-0	3,500	748	4,550	5,298	0	175	599	227	826	0
		$88,500	$12,500	$76,000	$88,500		$13,800	$10,000	$3,800	$13,800	

Assumptions:

a. 100 non-level annual premium policies issued on June 30, 1979.

b. Projected premium receipts based on historical experience modified for current trends or company projections if historical experience is not available. 1979 premiums include $12,500 "additional" first-year premiums.

c. Mortgage loan balances decrease only 8% in the first 10 years (30 year loans) and accordingly no effect has been given to the decrease in coverage in the above illustration.

d. Unearned premiums include the unearned portion of the additional first-year premiums and 50% of the first year level and renewal premiums received in each year.

e. 1979 acquisition costs allocated to new non-level premium policies are $10,000 (excluding costs associated with "level" first-year premiums). Acquisition costs associated with level first-year and renewal premiums are 5% of premiums received.

f. Deferred acquisition costs include the unamortized portion of first-year and renewal acquisition costs.

Notes:

1. Amortization of additional first-year premiums is 16.4% of level first-year and renewal premiums earned during the year. The 16.4% represents the additional first-year premiums ($12,500) divided by projected premium receipts ($88,500) less additional first-year premiums ($12,500). $\frac{12,500}{88,500 - 12,500} = 16.4\%$

2. Amortization of first-year acquisition costs is 11.3% of total earned premiums. The 11.3% represents first-year acquisition costs (excluding costs associated with "level" first-year premiums) -- $10,000 divided by total projected premium receipts $88,500.

3. This illustration assumes that projected and actual renewal premiums will be the same. In practice, when significant differences arise, the predetermined amortization amounts (for both additional first-year premiums and acquisition costs) will have to be adjusted to properly amortize the deferred revenue and expense in relation to actual renewal premiums.

Appendix C

Illustration of Accounting for Level Premiums and First-Year Acquisition Costs

This appendix illustrates one method of implementing the accounting principles recommended in this issues paper. It is not intended to be considered as the only acceptable method.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
						Acquisition Costs Expensed			
Calendar Year	Projected Policies in Force (a)	Projected Premium Receipts (b)	Earned Premiums	Unearned Premiums (c)	Acquisition Costs Incurred	Amortization of First Acquisition Costs	Level First-Year and Renewal Acquisition Costs	Total	Deferred Acquisition Costs (e)
1979	100	$14,500	$ 7,250	$7,250	$10,725	$ 805	$ 362	$ 1,167	$9,558
1980	96	13,920	14,210	6,960	696	1,577	711	2,288	7,966
1981	87	12,615	13,267	6,308	631	1,473	663	2,136	6,461
1982	74	10,730	11,673	5,365	536	1,296	584	1,880	5,117
1983	62	8,990	9,860	4,495	450	1,094	493	1,587	3,980
1984	55	7,975	8,483	3,987	399	942	424	1,366	3,013
1985	43	6,235	7,104	3,118	312	789	355	1,144	2,181
1986	33	4,785	5,511	2,392	239	612	276	888	1,532
1987	25	3,625	4,204	1,813	181	467	210	677	1,036
1988	18	2,610	3,118	1,305	130	346	156	502	664
1989-98	15-0	4,350	5,655	-0-	218	599	283	882	-0-
		$90,335	$90,335		$14,517	$10,000	$4,517	$14,517	

Assumptions:

a. 100 level annual premium policies issued on June 30, 1979.
b. Projected premium receipts based on historical experience modified for current trends or company projections if historical experience is not available.
c. Unearned premiums represent 50% of the premium receipts for the year.
d. 1979 acquisition costs allocated to new level premium policies are $10,000 (excluding acquisition costs equal to renewal acquisition cost rate of 5% of premium receipts).
e. Deferred acquisition costs include the unamortized portion of first-year and renewal acquisition costs.

Notes:

1. Amortization of first-year acquisition costs is 11.1% of earned premiums. The 11.1% represents first-year acquisition costs (excluding costs equal to renewal acquisition cost rate) - $10,000 divided by total projected premium receipts of $90,335.
2. The above illustration assumes that projected and actual renewal premiums will be the same. In practice, when significant differences arise, the predetermined amortization of first-year acquisition costs will have to be adjusted to properly amortize such costs in relation to actual renewal premiums.