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Statement of Position on

78-6

Accounting for Property and Liability Insurance Companies

July 28, 1978

Proposal to the
Financial Accounting Standards Board
to Amend AICPA Industry Audit Guide
Audits of Fire and Casualty Insurance Companies

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

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American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

July 28, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting for Property and Liability Insurance Companies, has been prepared on behalf of the accounting standards division by the AICPA Insurance Companies Committee and approved by the AICPA Accounting Standards Executive Committee. It proposes amendments to the AICPA industry audit guide, Audits of Fire and Casualty Insurance Companies.

The statement of position presents the division's recommendations on significant accounting issues related to property and liability insurance companies and amends those sections of chapter 9 of Audits of Fire and Casualty Insurance Companies that discuss the accounting practices followed in the industry.

Representatives of the division are available to discuss this proposed statement of position with you or your representatives at your convenience.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

Accounting Standards Division

Accounting Standards Executive Committee

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Table of Contents

	Page
Introduction	7
Premium Revenue Recognition	8
Discussion	8
Conclusions	9
Deferred Acquisition Costs	10
Discussion	10
Conclusions	11
Premium Deficiencies	12
Discussion	12
Determination of Premium Deficiencies	12
Anticipated Expenses Subsequent to Acquisition	13
Anticipated Investment Income	13
Financial Statement Presentation	16
Conclusions	17
Determination of Premium Deficiencies	17
Anticipated Expenses Subsequent to Acquisition	17
Anticipated Investment Income	17
Financial Statement Presentation	18
Losses	18
Discussion	18
Basis of Recognition	18
Salvage and Subrogation	18
Recognition of the Time Value of Money	18
Conclusions	21
Basis of Recogniton	21
Salvage and Subrogation	21
Recognition of the Time Value of Money	21
Loss Adjustment Expenses	22
Discussion	22
Conclusions	22
Reinsurance	22
Discussion	22
Conclusions	23

Policyholder Dividends and Contingent Commissions 24
Discussion 24
Conclusions 24

Valuation of Investments and Recognition of Related
Realized and Unrealized Gains or Losses 24
Discussion 24
Conclusions 26

Real Estate 27
Discussion 27
Conclusions 27

Accident and Health Insurance 27
Discussion 27
Conclusions 28

Transition 28

Accounting for Property and Liability Insurance Companies

Introduction

1. The AICPA Insurance Companies Committee is in the process of revising the AICPA industry audit guide, *Audits of Fire and Casualty Insurance Companies* (referred to in this statement of position as the guide). The term *property and liability insurance companies* is the current terminology used to describe fire and casualty insurance companies and, therefore, is used throughout this statement of position. The committee has reviewed the section of the guide dealing with variances between (*a*) generally accepted accounting principles and (*b*) practices prescribed or permitted by insurance regulatory authorities and has identified areas in which existing practice varies, including areas in which further clarification of the guide seems necessary, and certain areas that were not discussed in the guide. This statement of position amends the guide to clarify and update those sections reviewed.

2. A discussion memorandum was issued in November, 1975, to obtain representative views on the appropriate accounting principles to be applied in the various areas under study from AICPA members, representatives of industry, and other interested parties. An exposure draft of a proposed statement of position was issued for comments on October 31, 1977. The responses to the discussion memorandum and exposure draft were considered in the preparation of this statement of position.

3. In recent years, accountants, investors, and other users of financial statements have expressed concern over the acceptability of accounting alternatives for similar business transactions. The accounting standards division believes that it is not desirable to have alternative accounting methods in the property and liability insurance industry. Therefore, this statement of position expresses the division's conclusions on accounting methods that should be used in the areas in which alternatives exist, except for the issues of (*a*) whether loss reserves should be discounted, which is discussed in paragraphs 34 through 41, and (*b*) whether anticipated investment income should be considered in computing premium

deficiencies, which is discussed in paragraphs 22 through 30. This statement of position does not apply to title insurance. The division's conclusions on accounting for title insurance are presently being considered by the AICPA's Insurance Companies Committee. Paragraphs 6 through 43 of this statement of position do not apply to mortgage guaranty insurance. The issues discussed in those paragraphs, as they relate to mortgage guaranty insurance, are also presently being considered by the insurance companies committee.

4. The division's conclusions set forth in this statement of position apply to financial statements of all property and liability insurance companies that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Those companies include, but are not limited to, stock companies, mutual companies, and reciprocal exchanges or interinsurance exchanges.

5. The interests of policyholders and the public in the financial integrity of the property and liability insurance companies makes it important that the solvency of those companies be continuously demonstrated to regulatory authorities. Consideration of those interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (statutory accounting practices).[1] Federal income taxation of property and liability insurance companies is also based primarily on statutory accounting practices. The use of generally accepted accounting principles, as discussed in this statement of position, should not be construed as an indication that those accounting principles should also be used in reporting to regulatory or taxing authorities.

Premium Revenue Recognition

Discussion

6. Premiums are generally collected as of the inception of the contract or installment period. Under statutory accounting practices, the premiums are recognized in income evenly over the con-

[1] Such practices have been prescribed by statute, regulation, or rule or have been permitted by specific approval or acceptance.

tract period, generally determined on a monthly or daily basis. That method, which was endorsed by the guide and has been generally accepted in the property and liability insurance industry, usually produces a proper association of premium revenue with losses and expenses that will be incurred over the contract period. However, some believe that a modification should be made to that basis of recognition if (*a*) the period of risk differs significantly from the contract period or (*b*) the incidence of risk, or the amount at risk, varies significantly during the contract period.

7. For the typical policy, the premium is fixed for the period of the contract. In most cases, the fixed amount is recognized over the contract period. However, for retrospectively rated and reporting-form policies, an estimated or deposit premium is collected which is adjusted at a subsequent date, based on experience. In some cases, the deposit premium serves as a means of financing and, therefore, may only be a portion of the estimated premium. Under statutory accounting practices, those premiums are usually accounted for in the following manner: (*a*) the original estimated or deposit premium is recognized evenly over the contract period with subsequent adjustments charged or credited to income as they occur, or (*b*) the ultimate premium is estimated, revised during the contract period to reflect current experience, and recognized evenly over the contract period. The guide is silent on that subject and practice varies.

Conclusions

8. In the insurance industry, the service provided is coverage; therefore, revenue should be recognized as that coverage is provided. The incidence of *losses* is not relevant to the recognition of revenue but is relevant to the recognition of costs, which should be recognized as losses are incurred.

9. In most instances, premiums should be recognized as being earned evenly over the term of the insurance contract determined on a monthly or daily basis as the coverage is provided. In those few instances in which the period of risk varies significantly from the contract term, the premium should be recognized evenly over the period of risk. Also, in those few instances in which the amount of coverage declines according to a predetermined sched-

ule, the premium should be recognized in proportion to the amount of coverage.

10. Premium adjustments (for example, adjustments on retrospectively rated and reporting-form policies) should be accounted for on the accrual basis using an estimate of the ultimate premium. The estimated ultimate premium should be revised to reflect current experience. In those rare situations in which the ultimate premium cannot be reasonably estimated, the accrual basis should not be used.

Deferred Acquisition Costs

Discussion

11. The guide discusses the accounting for costs incurred in connection with writing insurance and obtaining insurance premiums. The guide indicates that statutory accounting practices, which require those costs to be charged to income as they are incurred, do not produce a proper association of costs and revenue. Therefore, the guide suggests that those costs be deferred and amortized over the contract period. That method has gained general acceptance in the industry.

12. The guide provides little guidance on the types of acquisition costs to be deferred. As a result, the guide has been subject to differing interpretations that have resulted in variations in practices. The principal interpretations of the guide are as follows:

a. Only those costs that vary directly with and are directly related to the production of business (new and renewal premiums written) should be deferred.
b. In addition to costs that vary directly, certain costs that vary indirectly and are directly related to the production of business should be deferred.
c. All costs related to the production of business should be deferred.

13. The guide describes only one method for estimating deferred acquisition costs referred to as "equity in unearned premiums." Some suggest that the method can distort net income if the relationship of costs incurred to premiums written varies signifi-

cantly from period to period. If deferred acquisition costs are estimated based on a percentage relationship of costs incurred to written premiums, they suggest that the percentage relationship once determined, except for any adjustment related to recoverability (that is, premium deficiency as that item is described in paragraphs 17 and 18), should continue to be applied to the applicable unearned premiums throughout the term of the policies. Furthermore, they suggest that acquisition costs should be amortized using more precise methods such as those used for amortizing unearned premiums in order to associate more properly those costs with premium revenue.

Conclusions

14. Costs that vary with and are directly related to the production of business (new and renewal premiums written during an accounting period) should be deferred and amortized to income as the related written premiums are earned. Certain expenses, such as commissions and premium taxes, vary directly with and are directly related to the production of new business and can be associated directly with specific revenue. Other expenses, such as salaries of certain employees involved in underwriting and policy issuance functions, inspection report fees, and fees paid to boards and bureaus, may vary indirectly with the production of business but are directly related to the premiums written during the period in which the costs are incurred. Those costs meet the criteria for deferral and association with the related premiums as they are earned. Certain other costs incurred during the period, such as depreciation, collection expenses and uncollectible accounts, professional fees, and general administrative expenses, do not vary directly with and are not directly related to the production of business and therefore should be expensed as incurred.

15. To apply those expense recognition principles, costs should be analyzed to determine whether they can be associated with revenue. Arbitrary percentage allocations of expense classifications do not meet those criteria and therefore should not be used.

16. Acquisition costs should be deferred and amortized using methods such as those used for amortizing unearned premiums in order to associate more properly those costs with premium revenue. The calculations should be made by reasonable group-

ings of business consistent with the company's manner of acquiring, servicing, and measuring the profitability of its insurance products. If deferred acquisition costs are calculated based on a percentage relationship of costs incurred to written premiums for a specified period of time, the percentage relationship and the time period used, once determined, should be applied to the applicable unearned premiums throughout the term of the policies, except for adjustments related to premium deficiencies.

Premium Deficiencies

Discussion

17. The guide states that "... since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term. . . ." In addition, the guide suggests that the premium should be adequate to recover any unamortized deferred acquisition costs. Paragraph 96 of FASB Statement no. 5 indicates that ". . . this Statement does not prohibit (and, in fact, requires) accrual of a *net* loss, that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated. . . ."

18. The guide does not use the term "premium deficiencies" (a term adopted by the division to describe the views of the FASB, which are set forth in paragraph 96 of FASB Statement no. 5). However, with respect to evaluating the recoverability of acquisition costs to be deferred, the guide suggests that consideration be given to (*a*) the anticipated loss ratio, (*b*) the anticipated loss expense ratio, and (*c*) the anticipated ratio of expenses subsequent to acquisition. It further suggests that the determination of those anticipated ratios requires an analysis of historical data plus knowledge of other factors, such as giving greater weight to the more recent loss experience and taking into account recent rate changes that would be reflected in the unearned premiums in the balance sheet.

19. *Determination of Premium Deficiencies.* Premium deficiencies are determinable (*a*) by individual lines of business,

(*b*) by reasonable groupings of business consistent with the company's manner of acquiring, servicing, and measuring profitability of its insurance products, or (*c*) in the aggregate.

20. *Anticipated Expenses Subsequent to Acquisition.* As stated above, the guide suggests that anticipated expenses subsequent to acquisition should be considered in evaluating the recoverability of acquisition costs to be deferred. However, the guide provides little guidance regarding what types of expenses subsequent to acquisition should be considered. The guide has been interpreted in various ways as follows:

a. Only anticipated losses, loss adjustment expenses, and unamortized deferred acquisition costs directly related to policies in force should be considered in determining premium deficiencies.

b. In addition to anticipated losses, loss adjustment expenses, and unamortized deferred acquisition costs, certain other underwriting expenses (maintenance expenses) should be considered, provided that those costs may be attributed to maintaining the policies in force.

c. Anticipated loss and loss adjustment expenses, together with all other underwriting expenses, should be considered in determining premium deficiencies.

d. Anticipated policy dividends should also be considered in the above tests.

e. Anticipated investment income should also be considered in the above tests.

21. *Anticipated Investment Income.* The guide states that ". . . since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term. . . ." Furthermore, the guide suggests that the premium should be adequate to recover any unamortized deferred acquisition costs. FASB Statement no. 5, paragraph 96, requires the accrual of a *net* loss that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated.

22. The guide is silent on whether investment income should be considered in the calculation of premium deficiencies; FASB Statement no. 5 does not give specific guidance for the calculation of premium deficiencies; current practice has been not to include investment income in the determination of premium deficiencies.

23. Some believe that the consideration of anticipated investment income in the computation of premium deficiencies is proper for the following reasons:

a. The concept of establishing premium deficiencies is founded on the generally accepted accounting principle of making provisions for foreseeable losses on contracts currently in force. That concept relates to losses on entire contracts and therefore should include all revenue and expenses relative to those contracts. An integral part of the revenue on insurance contracts is the investment income that will be earned on the funds generated by the collection of premiums in advance of the payment of losses and expenses on those contracts.

b. The concept of accruing for loss contracts, that is, premium deficiencies, differs from discounting of loss reserves in that the premium deficiency calculation relates to the estimation of future revenue and expenses relative to particular loss contracts, while the concept of discounting loss reserves relates to a currently established liability for losses incurred. Furthermore, the inclusion of investment income is a recognition of interest that will be earned on contract funds that have been collected, while the discounting of loss reserves recognizes the time value of money that relates to funds that may be in excess of the actual funds available for investment on particular loss contracts. Hence, the investment income in the premium deficiency calculation relates to actual funds available for investment, while the discounting concept imputes investment income on funds that may not necessarily have been generated by those particular contracts.

c. The incidence of recognition of investment income related to unprofitable contracts should be different from the incidence of recognition of investment income related to profitable contracts because of the nature of the contracts. The investment income on profitable contracts should be recognized as earned

following the generally accepted accounting principle of not anticipating gains. However, the investment income relative to loss contracts should be used in determining the "net" loss relative to those contracts in accordance with the generally accepted accounting principle of recognizing *net* losses on unprofitable contracts. As the concept of loss recognition pertains to a "net" loss, it is contemplated that the calculation should include accrual of all anticipated costs and all anticipated revenue relative to those contracts.

24. Others believe that anticipated investment income should be considered in the calculation of premium deficiencies for the above reasons, but that it would be inconsistent to recognize that investment income and not discount loss reserves. They believe that the recognition of the time value of money results in financial statements that are more in accord with economic reality but cannot support recognizing the effects of anticipated investment income only in the case of premium deficiencies (see paragraphs 34 through 38, "Recognition of the Time Value of Money"). They further believe that to do so would create an unnecessary difference in the application of the matching concept to profitable and unprofitable contracts. Furthermore, they point out that the methodology involved in using investment income in the computation of premium deficiencies is very similar to discounting loss reserves, and, if loss reserves were discounted, the question of using investment income in the computation of premium deficiences would be moot.

25. Some believe that anticipated investment income should not be considered in the calculation of premium deficiencies for the following reasons:

a. FASB Statement no. 5 defines a net loss, which the division describes as a premium deficiency, as "a loss in excess of deferred premiums." They believe that the term "deferred premiums" is intended to mean "unearned premiums" as commonly used in the insurance industry. In expanding on that view, the guide further indicates that a premium should also be adequate to recover deferred acquisition costs and expenses subsequent to acquisition. The losses and expenses referred to do not suggest that losses and expenses should be

estimated any differently for that purpose than for financial statement presentation. Thus, they believe the term needs no further clarification and indicates no intention on the part of the FASB to consider investment income as a source of revenue in determining a net loss.

b. Furthermore, they believe that including investment income in the computation of premium deficiencies is not otherwise supported by current generally accepted accounting principles applicable to the determination of asset values. In testing the recoverability of asset values, they believe it may be proper to consider income *directly attributable* to that asset during the recovery period. In those cases, the income considered can be identified as being directly related to the asset being evaluated. In this situation, the asset being tested for recoverability is a deferred charge, which does not and could not generate income. The investable funds generated by the related unearned premiums cannot be segregated and identified with specific contracts. Even if a segregation were possible, they suggest one might find that contracts that are evidencing possible future deficiency problems have already consumed more funds in paying losses to date than they generated in total.

26. *Financial Statement Presentation.* Some believe that, except in rare instances, future net losses cannot be estimated any more reasonably than catastrophes. Therefore, they believe that the provisions of the guide and FASB Statement no. 5 have little, if any, applicability in practice in this area. Others believe that, while future net losses may not be as reasonably estimable as liabilities for incurred losses, they can be estimated with sufficient reliability to determine whether there will be a net loss on the contract. Therefore, to comply with the guide and the requirements of FASB Statement no. 5, they suggest the following methods to provide for premium deficiencies:

a. A premium deficiency should first be recognized by writing off any unamortized deferred acquisition costs to the extent required. Should the premium deficiency be greater than the unamortized deferred acquisition costs, loss reserves should be provided for an additional deficiency. This method recognizes that an asset has been impaired and that the impairment

should be recognized before any additional liabilities are recorded.

b. Additional loss reserves should be provided for the full amount of the premium deficiency with no adjustment to deferred acquisition costs. This method is supported by the view that the original premium contemplated the acquisition costs and that the deficiency is caused by losses in excess of those anticipated at the time premiums were established.

c. Unearned premiums should be increased by the amount of a premium deficiency. This method is supported by the view that the premium deficiency cannot be attributed to either the acquisition costs or additional losses.

Conclusions

27. *Determination of Premium Deficiencies.* Premium deficiencies should be determined by reasonable groupings of business consistent with a company's manner of acquiring, servicing, and measuring the profitability of its insurance products.

28. *Anticipated Expenses Subsequent to Acquisition.* In those instances in which expected losses and loss adjustment expenses, maintenance expenses, policyholder dividends, and unamortized deferred acquisition costs exceed the related unearned premiums, a provision for the anticipated premium deficiency should be provided (in accordance with FASB Statement no. 5, paragraph 96).

29. Expected losses and loss adjustment expenses, expected policyholder dividends, and unamortized deferred acquisition costs should be considered in determining premium deficiencies. In addition, certain other underwriting expenses (maintenance expenses) should also be considered, provided those costs can be attributed to maintaining the policies in force.

30. *Anticipated Investment Income.* Although this statement of position discusses the issue of whether anticipated investment income should be considered in computing premium deficiencies, no conclusion has been reached. Because of the importance of that issue, the division believes that it should expose for public comment its conclusions on the issue in a separate statement of position. Until the issue is resolved, companies that consider

anticipated investment income in computing premium deficiencies should disclose that fact in their note on accounting policies together with the effects on the financial statements.

31. *Financial Statement Presentation.* A premium deficiency should first be recognized by writing off any unamortized deferred acquisition costs to the extent required. Should the premium deficiency be greater than the unamortized deferred acquisition costs, a separate liability should be provided for the excess deficiency. That method recognizes that an asset has been impaired and that the impairment should be recorded before any additional liabilities are recorded.

Losses

Discussion

32. *Basis of Recognition.* Under statutory accounting practices, losses are recognized as incurred. Estimated liabilities are established for losses that have been reported, and additional estimates are made for losses that have been incurred but have not yet been reported to the company. That accounting method was endorsed by the guide, has been generally accepted by industry, and is reaffirmed in FASB Statement no. 5. For losses that are historically settled over a period of years, the estimates generally include the effects of inflation and other social and economic factors on the ultimate dollar cost of settlement; the effects are generally measured using information based on historical and reasonably foreseeable events and trends.

33. *Salvage and Subrogation.* Regulatory authorities generally do not permit recognition of estimated amounts of salvage and subrogation recoverable on paid and unpaid losses. The guide is silent on that subject and practice varies.

34. *Recognition of the Time Value of Money.* Some regulatory authorities permit liabilities for losses to be determined based on the present value of future payments for those types of losses that are payable in fixed installments over a long period of time, such as certain workers' compensation and disability insurance claims. Discounting of loss reserves, or the recognition of the time value of money, for other types of claims not expected to be

settled in one year is generally not permitted. Under generally accepted accounting principles, losses are generally recorded following statutory accounting practices. The guide is silent on that subject and practice varies.

35. Those who believe that liabilities for losses and loss adjustment expenses should be stated at their present value suggest that investment income, excluding investment income attributable to stockholders' (members') equity, is an inextricable part of insurance operations, and present value concepts should be applied to all liabilities that are not expected to be settled in one year, provided that the period for settling the losses can be reasonably estimated. In support of that viewpoint, they cite the fact that at least fifteen states are now taking investment income into consideration in determining premium rates. They believe that further support comes from a review of the economic history of the insurance industry over the last fifty years in which investment income exceeded $29 billion (excluding investment gains of $5 billion), while underwriting losses aggregated slightly in excess of $2 billion over the same period. From that perspective, they believe it is undeniable that if the insurance industry had to depend solely on premium revenue to cover claim costs, acquisition costs, and underwriting expenses, it simply would not survive.

36. Some believe that all liabilities for losses and loss adjustment expenses not expected to be settled in one year should be stated at their present value. Those who support that view believe that—

a. Recognition of the time value of money results in financial statements that are more in accord with economic reality than is the case without discounting. The economic history of the insurance industry and the present environment demonstrate that investment income and underwriting results are interrelated.

b. Valuing loss reserves at their present value is consistent with the generally accepted accounting principle of matching related revenue and expenses. Premium revenue would be matched against the estimated present value of claims incurred, while investment income would be matched against

the interest added to the reserves. If losses are not discounted, premium revenue is matched against the estimated total amount to be paid on claims incurred, while investment income has no offset.

c. Anticipated investment income plays a significant role in determining premium rates. Premiums on lines of business in which losses are settled in a relatively short period of time are generally higher in relation to anticipated losses than premiums on lines of business in which a substantial portion of the losses are settled over a period of years.

d. Current insurance accounting principles are inconsistent, inasmuch as reserves on life, annuity, and disability policies issued by life insurance companies are discounted, while long-term reserves of property and liability insurance companies are not.

e. Although the use of present values involves estimates of the timing of future payments, the estimates would be based on historical experience modified for current trends. The use of discounted loss reserves should not imply greater precision than gross dollar reserves because all elements of the loss reserve (gross dollar value, salvage and subrogation recoverable, and payment pattern)are estimates.

37. Those who support discounting, or the recognition of the time value of money, believe that the issue is so significant to the determination of financial position, results of operations, and changes in financial position of property and liability insurance companies that financial statements will continue to be interpreted differently until the issue is resolved.

38. Others believe that present value concepts should be applied only to those types of losses that are payable in fixed installments over a long period of time, such as workers' compensation and other forms of disability insurance. Those who support this view believe that—

a. Those liabilities are contractual obligations to pay money on fixed or determinable dates as contemplated in APB Opinion 21, *Interest on Receivables and Payables.*

b. Present value concepts should be applied only to those types of losses because the application of present value concepts to

other types of losses involve estimates of both the amounts and the timing of payments, and there is too much subjectivity inherent in establishing estimates of losses that will not be paid until some undetermined future date to permit those losses to be stated at their present value. To do so would imply a greater degree of precision than is warranted.

Conclusions

39. *Basis of Recognition.* Under generally accepted accounting principles, losses should be recognized in the financial statements as incurred, including estimates for incurred but not reported losses. Provisions for unpaid losses should be based on the best estimate of the ultimate cost of settlement (including the effects of inflation and other social and economic factors), reduced by estimated salvage and subrogation recoveries, using past experience adjusted for current trends and any other factors that would modify past experience. Changes in loss estimates resulting from the continuous review process and differences between estimates and ultimate payments should be reflected in income of the period in which the estimates are changed.

40. *Salvage and Subrogation.* Estimated amounts of salvage and subrogation recoverable on paid and unpaid losses should be recorded as a reduction of unpaid losses with disclosure of the amounts deducted.[2]

41. *Recognition of the Time Value of Money.* Although this statement of position discusses the issue of whether loss reserves should be discounted, that is, whether the time value of money should be considered in determining loss reserves, no conclusion has been reached. Because of the importance of that issue, the division believes that it should expose for public comment its conclusions on the issue in a separate statement of position. Until the issue is resolved, companies that discount loss reserves or loss adjustment expenses[3] should disclose that fact in their note on accounting policies together with the effects on the financial statements.

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[2] The insurance companies committee has noted that this accounting practice appears to be uniform; accordingly, disclosure of the estimated amount of salvage and subrogation is considered adequate, rather than presenting the estimated amount as an asset.

[3] See paragraphs 42 and 43.

Loss Adjustment Expenses

Discussion

42. Statutory accounting practices require that all costs associated with the settlement of losses 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. No exception to that practice was presented in the guide, and the practice has been accepted in industry.

Conclusions

43. All expenses expected to be incurred in connection with the settlement of unpaid losses should be accrued. Certain of those expenses, such as legal and adjusters' fees, can be associated directly with specific losses paid or in the process of settlement. Other of those expenses, such as the internal costs of the claims function, cannot be associated with specific losses but are related to losses paid or in the process of settlement.[4]

Reinsurance

Discussion

44. Under statutory accounting practices, amounts recoverable from reinsurers related to paid losses are classified as an asset, whereas amounts recoverable on unpaid losses and for ceded unearned premiums are offset against the related liability accounts. The guide is silent on that subject, and the practice is generally accepted in the industry. However, some believe that all amounts recoverable from reinsurers should be classified as assets, subject to appropriate valuation allowances, rather than as offsets to liability accounts on the basis that generally accepted accounting principles do not permit offsetting receivables and payables to unrelated parties.

45. Those who support the statutory accounting practice believe that reinsurance is inextricably linked to the basic policy transaction. For example, if the amount of commercial fire coverage required exceeds the retention limit of any one company,

[4] See paragraph 41.

the several companies insuring the risk could either issue separate policies for their portion of the risk or one company could issue a single policy for the total coverage and reinsure the coverage in excess of its retention limit. In either case, the net financial statement result is the same and form should not prevail over substance.

46. Under statutory accounting practices, reinsurance premiums ceded are reported as a reduction of written and earned premiums. The guide is silent on that subject and the practice is generally accepted in the industry. Some believe the purchase of catastrophe insurance coverage by a company is not a true sharing of risk and, therefore, the premiums should be treated as operating expenses as opposed to a reduction in written and earned premiums. Those who support the statutory accounting practice believe, as stated above, that reinsurance is inextricably linked to the basic policy transaction and that a distinction cannot be made between a sharing of risk and the purchase of insurance.

Conclusions

47. Amounts recoverable from reinsurers that are related to paid losses and loss adjustment expenses, if applicable, should be classified in the financial statements as assets, subject to appropriate valuation allowances. Estimated amounts recoverable from reinsurers that are related to unpaid losses and loss adjustment expenses should be deducted from the unpaid losses and loss adjustment expenses with disclosure of the amounts deducted.[5] Ceded unearned premiums do not represent receivables; therefore, those amounts should be netted against the related unearned premiums. Receivables and payables from the same reinsurer, including funds withheld, should be offset. Reinsurance premiums ceded and reinsurance recoveries on losses may be netted against the respective earned premiums and incurred losses in the income statement.

48. Companies should disclose (*a*) the nature of their reinsurance activities, (*b*) reinsurance premiums assumed and ceded that are included in or deducted from earned premiums (disclo-

[5] The insurance companies committee has noted that this accounting practice appears to be uniform; accordingly, disclosure of the estimated amount of reinsurance is adequate, rather than presenting the estimated amount as an asset.

sure should also be made on a written premium basis if the difference is material), and (*c*) premiums and recoveries on catastrophe type reinsurance contracts deducted from premiums earned and losses incurred, respectively.

Policyholder Dividends and Contingent Commissions

Discussion

49. Under statutory accounting practices—

a. Policyholder dividends are generally recorded as liabilities when declared by the board of directors.

b. Contingent commissions are recognized in financial statements on either the accrual basis, a modified cash basis (that is, accrual for commissions on expired contracts), or the cash basis.

Conclusions

50. Generally accepted accounting principles require the use of accrual basis accounting; therefore—

a. Dividends should be accrued using best estimates of the amounts to be paid.

b. Contingent commissions receivable or payable should be accrued over the period during which the related profits are recognized.

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.

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 are not appropriate for bonds, common stocks, or preferred stocks.

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.

Accident and Health Insurance

Discussion

64. Accident and health insurance contracts are issued by both property and liability insurance companies and life insurance companies. Currently, those companies may account for their

accident and health insurance contracts differently depending on which audit guide the companies follow.

Conclusions

65. The accounting for accident and health insurance contracts should be the same irrespective of the company issuing the contracts. The applicable provisions of this statement of position should be applied to short-term accident and health insurance contracts. The provisions of the industry audit guide, *Audits of Stock Life Insurance Companies*, should be applied to long-term accident and health insurance contracts. Individual and group contracts that are noncancelable, collectively renewable, or guaranteed renewable should be considered long-term contracts. Contracts that are renewable at the option of the company (cancelable contracts) may also be considered long term if it can be demonstrated that they are likely to remain in force for a reasonable period of time, similar to guaranteed renewable contracts. All other contracts should be accounted for as short-term contracts.

Transition

66. The conclusions in this statement of position should be applied to financial statements of property and liability insurance companies issued for annual and interim periods beginning after December 31, 1978. Earlier application is encouraged. The conclusions in this statement of position should be applied retroactively, and financial statements presented for prior periods should be restated. The individual effects of changing to the accounting principles in this statement of position should be disclosed in the financial statements.