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Bird's-eye view of accounting in the life insurance industry

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A Bird's-Eye View of Accounting in the Life Insurance Industry

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Life insurance follows one of the most exceptional methods of accounting in existence today, a fact that in itself makes life insurance accounting work interesting. In addition, the continued and substantial growth of most life insurance companies and developments in state regulation and in the Federal income tax laws relating to life insurance companies make life insurance accounting even more intriguing.

FINANCIAL STATEMENTS

The financial statements of a life insurance company are prepared on what is frequently called the liquidation basis of accounting. This method is in contrast with that used in the financial statements of most commercial concerns, which are prepared on the going-concern basis. This distinction is responsible for most of the extraordinary features of life insurance accounting. Presumably a life-insurance-company balance sheet prepared on the liquidation basis should reflect the net assets realizable by the company if it were liquidated at the balance-sheet date. This would not be true however as would be apparent from comparing the market value of such a company's investments in bonds with the value reflected in its balance sheet. The liquidation basis does, however, result in very conservative accounting by restricting the type of, and also the amount at which, assets may be included in the balance sheet. This circumstance will become apparent when specific financial-statement items are discussed later.

Uniform Annual Statements

The insurance departments of the various states regulate the life insurance industry within their borders and determine the reporting and other requirements to be adhered to. The primary concern of insurance authorities is to protect the policyholder rather than the stockholder, which accounts for the restrictions imposed upon life insurance companies and for much of the conservatism of their financial statements. An insurance company must comply with the laws of the state in which it is chartered and with the laws of all states in which it is licensed to transact business. There are, of course, differences in the laws of the various states, a fact which on the surfact might appear to be conducive to chaotic conditions in the industry. Fortunately this does not happen, primarily because of the National Association of Insurance Commissioners. This Association is comprised of the commissioners or officials of the various state insurance departments. One of its primary functions is to promote uniformity in the laws and regulations of the various states. For example, the Association has adopted a uniform annual statement form, which is used by all states and is referred to as the convention blank. Each state might, however, have its own restrictions on the type and amount of certain assets to be included in the annual statement. Life insurance accounting, therefore, requires a knowledge of the restrictions imposed by the states in which a company is licensed to transact business.

Examinations

The insurance examiners of each state make periodic examinations of the annual statements of domestic and foreign insurance companies licensed to do business within their state. However, in order to avoid multiple examinations of a specific company, joint examinations are frequently made in which representatives of several state insurance departments may participate.

General Ledger

As a general rule, the general ledger of a life insurance company is maintained substantially on a cash basis. This practice is recognized in the form of the convention blank since a large part of the exhibits and schedules included therein are designed to adjust cash-basis ledger balances automatically to the accrual basis reflected in the statements of assets, liabilities, surplus and other funds and in the summary of operations. Therefore, one of the prime differences in life insurance accounting, as compared to accounting for most commercial concerns, is the lack of agreement of financial statements with the general ledger.

By way of illustrating the differences between the general ledger and the financial statements, the following terms might be considered. Exhibit 13 of the convention blank is entitled "Assets." This exhibit has four columns as follows: (1) ledger assets, (2) non-ledger assets, (3) assets not admitted, and (4) net admitted assets. The ledger assets column is completed by reference to the general ledger. Assets of the company not included in the general ledger are included in the non-ledger assets column as, for example, interest due and accrued. Assets not allowed to be included as assets in the financial statements are entered in the assets-not-admitted column; an example of not-admitted assets would be agents' balances receivable (or any other unsecured receivable for that matter). Non-ledger assets are added to ledger assets and assets not admitted are deducted from the resulting total to arrive at the amounts to be included in the net-admitted-assets column. Admitted assets means assets valued on a basis permitted by state regulatory authority and permitted to be included for balance-sheet purposes in the annual report to state regulatory authority. The investment in stocks account might have entries in all columns as follows: the ledger-assets column would show the cost of stocks owned; the non-ledger assets column would show the excess of stocks valued at market over the cost thereof; the assets-not-admitted column would reflect the carrying value of investments disallowed as admissible assets by state regulatory authority; and the net-admitted-assets column would show the amount at which the investment in stocks is to be included in the balance sheet.

Balance Sheets—Assets

A brief discussion of some of the more important items included in life-insurance-company financial statements might be helpful in obtaining a "feeling" of life insurance accounting. The discussion will be general and should be so considered since there may be numerous specific exceptions to the general rules referred to.

Investments in bonds qualifying for amortization are stated at amortized cost and bonds not so qualifying are stated at values prescribed by the National Association of Insurance Commissioners. The Valuation Committee of the National Association of Insurance Commissioners publishes annually its book on valuations of securities as of December 31. In order to value bonds and stocks for statement purposes reference must be made to this book. In general, it indicates those bonds meeting the committee's tests for amortization, values stocks and bonds having a public market at approximate year-end market quotations, and values stocks and bonds not having a public market at prices otherwise determined by the Committee.

Investments in stocks are valued at prices set forth in the book on valuation of securities previously referred to.

Mortgage loans on real estate usually represent a large investment but they present relatively few problems. Admitted assets are usually limited to first liens and loans not in excess of a stipulated percentage of the appraised value of the mortgaged property.

The annual statement provides for reporting real estate at market value less encumbrances. As a practical matter, however, real estate is frequently reported at depreciated cost less encumbrances so long as such value does not exceed market value less encumbrances. Personal property is not included in the balance sheet but is either expensed at the time of acquisition or set up as a not-admitted asset and depreciated. One exception to this rule applies to certain data processing equipment which may be considered an admitted asset. The rental value of real estate owned and occupied by the company is included in investment income with contra charges to the appropriate departmental expense accounts.

The last item on the asset side of the balance sheet that will be mentioned is "life insurance premiums and annuity considerations deferred and uncollected." This account includes premiums due or past due but falling within the grace period allowed by the company, and also premiums not yet due under the terms of the policy. These premiums are reduced by a factor representing the estimated cost of collection, etc. The policies are included in insurance in force in computing the life insurance and other reserves.

Balance Sheet—Liabilities

The major items on the liability side of the balance sheet are the policy reserves. These reserves apply to all policies in force and are actuarial determinations based on specified mortality tables with certain assumed rates of interest. The calculation of the policy reserves, therefore, falls into the actuarial field rather than the accounting field. The amount of reserve provided for each policy takes into consideration, among other things: (1) the amount of the annual premium; (2) the cost of insurance, which takes into account the age of the insured; (3) the assumed rate of interest to be earned; and (4) the maturity value of the policy. A further over-simplification might be made to the effect that the policy reserves at a particular date represent an actuarial determination of the amount of the company's contracted liability to its policyholders at that date.

The liability side of the balance sheet also includes policy and contract claims, amounts held and accumulated for the benefit of policyholders, and the usual accruals and payables, none of which would appear to warrant further discussion at this time.

The last item to be mentioned under liabilities is the mandatory securities valuation reserve included in the annual statement under miscellaneous liabilities. This reserve is provided out of unassigned surplus and was created primarily for the purpose of minimizing the effect on unassigned surplus of fluctuations in market values of stocks and bonds owned. The amount of the annual additions to and deductions from this reserve is equivalent to the realized and unrealized gains and losses on bonds and stocks, less any Federal income taxes on long-term capital gains, and specified percentages of the admitted values of investments in bonds, stocks, and savings and loan shares. There are minimum and maximum limitations with respect to the amount of the reserve.

Surplus Accounts

Earned and capital surplus are included in a single surplus account entitled "Unassigned Surplus." Unassigned surplus includes, among other things, unrealized capital gains and losses on investments without providing for any applicable Federal income taxes on the capital gains.

Income Statement

The income statement is entitled "Summary of Operations" and includes underwriting income and investment income. It does not include the net realized or unrealized capital gains or losses on investments; these items are entered directly in the unassigned surplus account. It should be observed, however, that Federal income taxes on long-term capital gains are included as a charge in the summary of operations. Another interesting point concerning operations is the fact that the summary of operations of a growing life insurance company will probably reflect a net investment income but in all probability will show a loss from underwriting (or insurance) operations. One of the major reasons, but certainly not the only reason, for the underwriting loss is the fact that commissions and other costs relating to the acquisition of new business and the writing of policies therefor are charged to operations in the year incurred rather than amortized over the expected life of the policy. Related also to the underwriting loss is the fact that first-year commissions to agents are usually considerably greater than renewal commissions. Conversely, in a period of declining business, these factors would tend to improve the reported underwriting gain. Beyond this, a discussion of specific items in the summary of operations would not appear to be necessary at this time; also the effect on operations resulting from the handling of certain of the specific assets and liabilities previosuly discussed will be readily apparent.

FEDERAL INCOME TAXATION

As to the status of Federal income taxation of life insurance companies, the summary that follows, taken in part from a recent prospectus, pretty well describes the broad general principles. Before 1958, life insurance companies were subject to Federal income taxes only on a portion of their net investment income and were not taxed on underwriting profits or capital gains. Under the Life Insurance Company Income Tax Act of 1959, applicable generally to 1958 and subsequent years, life insurance companies are taxed not only on net investment income but also on underwriting income and on capital gains. In general, life insurance companies are taxed on taxable investment income or gain from operations, whichever is smaller, plus one-half of any excess of gain from operations over taxable investment income. During the years 1959 through 1961 net long-term capital gains were subject to a separate tax at the rate of 25 per cent against which a net loss from operations could not be offset. Effective with the year 1962 such gains are included in the general tax base with a 25 per cent alternative tax available where advantageous. Beginning January 1, 1959, the one-half of the excess of gain from operations over taxable investment income not currently taxed (with certain adjustments) is accumulated in a memorandum account for tax purposes entitled "Policyholders Surplus Account." Federal income taxes on this untaxed income in the "Policyholders Surplus Account" are incurred: (1) when and to the extent the "Policyholders Surplus Account" exceeds a prescribed maximum or (2) when and if distributions (other than stock dividends) are made to stockholders in excess of currently taxed income accumulated since December 31, 1957. By way of explanation, it might be pointed out that Congress was exercising caution in the taxation of life insurance companies under the Life Insurance Company Income Tax Act of 1959 when it permitted the addition of a portion of the gain from operations to the "Policyholders Surplus Account" free of tax; this was, as is apparent, for the benefit and protection of the policyholders. At the same time, Congress took the position that a distribution to stockholders out of the "Policyholders Surplus Account" was in effect a determination by the company that the amounts thereof were not needed for the protection of policyholders and therefore were taxable at regular tax rates.

SUMMARY

The foregoing discussion was directed toward some of the more distinctive features of life insurance accounting and regulation and areas where certain life insurance accounting practices differ from generally accepted accounting principles. There are many other points in these categories that would probably be of interest. Mere mention of the volume of investments and related investment income, insurance policies in force, and the related premium receipts (many of which are on a monthly basis) and policy history and reserve records, claim files, etc., serves to illustrate the possibilities for many systems and procedural problems beyond the scope of this paper.