Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

ACCOUNTS OF INSURANCE COMPANIES

Question: In the course of a recent audit of an insurance company the question was raised as to whether or not certain entries should be placed on the books for the purpose of bringing the accounts into agreement with reports to state regulatory bodies and published reports to stockholders.

We contended that some entry should be made in the accounts at the close of a fiscal period to record the reserve for unearned premiums, reserve for losses in process of adjustment, reserves for taxes and expenses, reserve for contingencies and investment interest accrued but not due. Furthermore, it was our opinion that there was no reason why some of the above reserves could not be left on the books, to be diminished by charges in the subsequent period when the items for which they provided were paid. We did grant that the entries setting up the reserve for unearned premiums and the reserve for losses in process of adjustment might be reversed at the opening of the following period. In addition to the above, we see no reason why an insurance company should not make regular provision in its records for accounts payable and some variation of the conventional form of purchase journal.

Our recommendation, as above stated, does not seem to be inconsistent with the requirements of state insurance department reports which are important factors for consideration in insurance accounting.

The chief accountant of the company contended, and was apparently supported by the fiscal officers of two or three other companies, to whom he directed inquiries, that the entries proposed by us should not be made on the books of an insurance company at the end of an accounting period and that the carrying of reserves for taxes and contingencies and accounts payable as regular accounts would be contrary to good insurance accounting practice.

Answer No. 1: It is quite true, as the chief accountant of the insurance company contends, that accounts for reserve for unearned premiums, reserve for losses, reserve for taxes and expenses, interest accrued, accounts payable, etc. are not generally carried on the books of an insurance company, but appear only in the statutory statements prepared for filing with state departments and for the published report to the stockholders.

An insurance company's general ledger will usually be found to contain only accounts for so-called ledger assets and the capital stock with a balancing liability account under some such general description as "excess of ledger assets over capital stock." Occasionally a surplus account, corresponding to the surplus shown in the statutory statement, may be carried and adjusted at the next statement date, in which case the balancing liability account would be entitled "excess of ledger assets over capital stock and surplus."

From a technical accounting standpoint, there can be little doubt, we believe, that an insurance company might keep its books in substantially the same manner as companies engaged in other businesses, but this is not the customary practice, and we feel that your correspondent will have considerable difficulty in convincing his client that the accounts should be kept on any other basis than that generally adopted by insurance companies. While we do not agree with the statement made by the chief accountant of the insurance company that to carry these accounts on the books would be contrary to good insurance accounting practice, we concede that it is contrary to customary insurance accounting practice.

Answer No. 2: It is our experience that insurance companies do not place such entries on their books at the close of each fiscal period. The various reports required periodically by state departments make it necessary, in view of the special form in which they must be submitted and the great volume of information called for, that the accounts of the reporting company be kept in a manner that will reduce to a minimum the work of preparing these reports. The data required for calculating accrued interest receivable not yet due, losses in process of adjustment, accrued expenses, and similar items, in order to give effect to them in the published reports, can readily be obtained from the subsidiary records. Were entries to be made recording such accruals in the general books at the close of each fiscal period, it would not only greatly increase the work of preparing the reports required to be filed periodically with state bodies, but would lead in the end to a great number of reversing entries at the beginning of the following period.

While the placing of such entries on the books at the close of each period would not, so far as we know, be inconsistent with the requirements of the insurance departments of the various states, it would, in our opinion, be contrary to the accounting practice of insurance companies. We do not consider it either necessary or desirable to make such entries.

Answer No. 3: I wish to advise you that the member who made the inquiry is incorrect in wanting to place upon the ledgers of the insurance company the liabilities for unearned premium reserves, loss reserves, taxes and expense reserve, contingency reserves and investment interest accrued.

In the case of fire-insurance companies and casualty-insurance companies it has been the universal practice in this country not to accrue the reserves on the books. There are two reasons for this: (1) The method of obtaining these reserves is largely mathematical and based on individual judgment and changes from day to day as the premiums are earned or as the situation as regards losses and expenses changes. Inasmuch as it is impossible to ascertain these liabilities without recourse to subsidiary records, it is useless to go through the formality of entering them by means of journal entries in the ledger. (2) The annual reports made to the various insurance departments are not on an accrued basis, with the exception of premiums written during the year. The reports start out with the ledger assets at the beginning of the year, to which are added the premiums written and other cash income, and from the total the cash disbursements are deducted. The resulting figure balances with the ledger assets at the end of the year.

These income and disbursement items, together with the ledger assets, are all obtainable from the trial balance of the company. The ledger assets, however, less the liabilities do not necessarily represent the company's surplus. There are additions to assets in the form of accrued interest, market value of securities over book value, salvages and reinsurance recoverable and other items peculiar to insurance companies, and they are deducted from the gross assets as above determined, premiums in course of collection more than 90 days past due, furniture and fixtures, printing and stationery, book value of ledger assets over market value and other deductions peculiar to insurance companies and it would be just as reasonable to set up all of these non-ledger assets and non-admitted assets on the books as to set up the reserves before mentioned.

There is another reason for not entering these various liabilities on the ledger and that is that the laws of the various states differ as to how these liabilities should be calculated. One state provides for an unearned premium of 50 per cent of the premiums in force running for one year or less while another state provides for the calculation of the unearned premium reserve on a pro-rata basis, and many states differ as to the calculation of the loss reserves.

To sum the matter up briefly, no benefit can result to the company or its accounting system in putting these items on its ledgers as they would not be capable of proof except through the subsidiary accounts.