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Accounting Questions: Treatment of Self-insurance reserves

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Accounting Questions

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ACCOUNTING TREATMENT OF SELF-INSURANCE RESERVES

Question: We should be greatly obliged for your opinion of the following question:

A mining company under the Utah compensation and employers' liability law elects to carry its own insurance. Provision has been made in its books by crediting reserve for compensation insurance with the amounts which it would have been required to pay as premiums if the insurance had been carried with the state insurance fund, and this reserve has been charged with actual payments made on account of its liability to employees or to their dependents.

From time to time awards were made by the state industrial commission and, by the end of 1932, the liability of the company for outstanding awards consisted of several industrial blind and total disability cases, under which the company is required to pay approximately $16 a week during the life of the injured employee, and several fatal accident cases for which awards have been made of approximately $5,000 each, payable in weekly instalments of $16 to the dependents of the former employee. In the fatal accident cases the amount outstanding is the original award less payments made on it to date.

The point concerning which we desire your opinion is whether the balance-sheet should reflect a liability for awards which already have been made and if so what is the proper method of computing the liability.

Under the industrial blind and total disability cases, taking insurance mortality statistics as the basis, and multiplying the weekly payment by the number of years of expected life of the insured at their respective ages and reducing this amount to its present worth say on a 6 per cent. basis, we find the liability to be in excess of the amount provided in the reserve set up on the books, and we also find that if the company should purchase annuities for these injured employees the cost would exceed the amount of reserve, giving consideration also to the liability for fatal accidents explained in the next succeeding paragraph. The question naturally arises as to whether insurance statistics are a fair basis on which to make this estimate for the reason that the persons to whom payments are being made under awards of the industrial commission are either blind or otherwise seriously injured and possibly the expectation of life would be quite different from that shown by insurance mortality statistics. Moreover, the number of cases involved is so small that there could be no confidence that average mortality rates would be applicable to them.

As to fatal accidents the awards are definite in amount and the liability may be approximately computed at its present worth subject to the determination of the interest rate to be used. While in some circumstances the liability may be terminated before the full amount of the award is paid, as for example by re-marriage of a widowed dependent, experience indicates that this is not an important factor to consider.

For federal income-tax purposes, the treasury department, the board of tax appeals and the courts have held that additions to a reserve of the nature described above are not deductible from gross income. Reference is made in particular to the decision of the board of tax appeals in *Spring Canyon Coal Company* v. *Commissioner*, docket number 23902, 25743, and Commerce Clearing House, Dec. number 4300. In the board decision reference is made to supreme court decisions of the state of Utah under the compensation act; and under these decisions it appears that the compensation provided for in the act is not to be considered in the sense of damages for injuries sustained but that it is compensation pure and simple. The board's decision in this case was affirmed by the court of appeals. In this case the petitioner appears to have claimed only that the additions to the reserve were deductible, and the question as to deductibility of awards actually made does not appear to have been raised.

From an accounting point of view, it appears to us that the sustaining of the accident and the resulting award by the industrial commission creates a real liability, and, even if it is an award for compensation and not for damages, provision should be made for it not later than the time at which the award is made, as the self-insurer is required to make the payments in the future without receiving any further benefit from the services of the injured employee.

Answer No. 1: Accident expense is practically as certain as any other expense and when the employer assumes the attendant risk there at once arises a liability —certain as to the event, contingent as to the amount. Experience—not stipulated premiums—is the practical basis for finding that contingent amount.

We should recommend a monthly charge against operations sufficient to set up an adequate general accident reserve and, as liabilities become fixed or determinable by award or otherwise, the transfer of such amounts (ascertained on any reasonable basis) from the general reserve to one or more specific reserves against which payments are charged. If in time the credit balance of the general reserve fails to afford or exceeds a reasonable provision for the company's potential risk, the monthly charge to operations would be adjusted accordingly. When cases covered by specific reserves are closed or modified, any differences between the original and adjusted figure would be transferred back to the general reserve.

To the specific question we should therefore reply that in our opinion the balance-sheet should reflect a liability for awards already made and, since there is no possibility of exactly computing the amount ultimately to be paid, conservative accounting would permit any method under which the maximum possible liability receives due consideration.

Answer No. 2: There seems to be no question that the awards made by the Utah state industrial commission constitute liabilities of the company for which provision should be made on the balance-sheet. The difficulty arises in calculating the exact amount of this liability at the balance-sheet date.

The proper method of calculating this liability is to compute the present worth of the estimated payments which will have to be made. In computing the present worth, the interest rate used should be equal to that which could be earned by the company upon a special fund set aside for the purpose of meeting these payments as they fall due. This interest rate would probably not be in excess of 3 per cent. or 3½ per cent. per annum. To use a higher rate would, in our opinion, understate the liability.

In the case of fatal accidents, the awards are definite in amount and can readily be calculated, ignoring the possibility of terminating the payments before the full amount of the award has been reached.

In the industrial blind and total disability cases, in which the award is a weekly payment during the life of the injured employee, it is necessary to estimate the number of weekly payments in each case. In the absence of any statistics relating to the expectation of life of industrial blind and totally disabled workers of various ages, it would seem that insurance mortality statistics would have to be used. Inasmuch as these tables are notoriously high, a reduction of about 25 per cent. from them could reasonably be made in calculating probable future payments to any group in average health. It might not be unreasonable to make a further reduction of 25 per cent. to allow for the shorter expectation of life of the blind and totally disabled former employees. However, through a consideration of individual cases it may be possible to raise or lower this percentage or to work out separate estimates for each case.