Audits of Accounts of Fire-Insurance Companies

Felix Hebert

The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 40 AUGUST, 1925 No. 2

Audits of Accounts of Fire-Insurance Companies*

By Felix Hebert

> No man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere error of judgment.

While the above quotation from Cooley's *Torts* may and probably does state the law applicable to auditors generally, yet if the auditor of an insurance company whose business is country-wide fail to seek out and correct errors that are to be found in its accounts, he may not suffer the penalities provided by law, but I can assure him that he will have visited upon him the criticisms and in some instances the execrations of some fifty varieties of insurance department employees from actuaries down to ordinary clerks.

In any discussion of this subject, we must not lose sight of the fact that insurance is the subject of supervision, not only so far as assets and liabilities are concerned, but also in respect of the character of undertakings, the nature of contracts, the risks assumed and the precise manner of conducting the minutest details of the business.

Nature of Accounts

As practically every detail of an insurance company's business may be subjected to official scrutiny, it is well to have some knowledge of the requirements of law in the several states where it is admitted to transact business and of the information required of it in its annual statements or reports. Whatever of resentment may be aroused in the minds of the insurance-company officials against the peremptory demands for the furnishing of data

*An address before the Accountants' Club of Southern New England, at Providence, Rhode Island.

concerning their business, we must not lose sight of the fact that such requirements must be met if such companies are to continue to transact their business. Therefore, it is the part of wisdom for insurance companies so to arrange their books and accounts that the desired information shall be readily available. Such a course not only meets with favor from the examiners who are called upon periodically to look over the affairs of companies, but will, I am convinced after some twenty years of experience both in a supervisory capacity and as an auditor of insurance accounts, generally produce results satisfactory from an accounting standpoint.

Seemingly, every insurance company has a different system of accounting, but the annual statement blank prescribed by the National Convention of Insurance Commissioners has had a considerable influence on the more recent systems installed and gradually, in the older companies, the accounts are being modified to meet the requirements of that blank.

As in every other kind of audit, the auditor of insurance accounts should familiarize himself with the system in use in the company's office. He should know the processes by which transactions become a part of the records of the company, the books that are in use and their purposes. It is presumed that the auditor will carry on his work without undue interference with the regular routine of the office and without taking up the time of clerks and officials unnecessarily. He should therefore know where books and records and accounts may be found. He should abstain, as far as possible, from calling upon officials or others for explanations of trivial matters, but if he feels that such matters demand an explanation he should await a favorable opportunity to approach his prospective informant, preferably making less important questions the subject of a part of an interview upon a more weighty topic.

Scope of this Discussion

In my discussion of this subject, I shall proceed, as logically as I am able, to tell of the different steps which I usually follow in verifying a company's accounts, always having in mind the several items appearing in the annual statement blank prescribed by the insurance departments of the several states and the requirements thereof, but omitting items of minor consequence.

I shall explain my method of verifying the receipts and disbursements, and the assets and liabilities, and of applying test checks where a complete verification would appear to be without the scope of the usual audit.

It must be borne in mind that fire-insurance companies differ in some respects and that they transact their business on different plans. There are stock companies, or those having capital stock, managed and controlled by the stockholders, and mutual companies, operated and managed by the policy holders. Again, there are the so-called "non-agency" companies, that is, those companies which employ no agents and pay no commissions for securing their business, and those which secure their business almost entirely from agents, usually on a commission basis. In the audit of an "agency company" the element of agents' balances and their daily and monthly reports must be taken into account. In the "non-agency" companies the policies are all written at the home offices so that the process of verification of these different classes must be varied somewhat and this I will explain as the divergence appears in the course of discussion of the items of the statement.

Annual Statement Blank

The underlying principle of the annual statement blank is that if the excess of receipts over disbursements in any given year be added to the assets at the beginning of the year, the sum will equal the assets at the end thereof.

In my discussion of the requirements of the statement blank I will explain the processes, taking up the items in the order in which they appear under various heads. I am led to this course, first, because the accounts of insurance companies usually lend themselves most readily thereto, and second, because my early training and experience have been such as to enable me to explain more clearly if not more concisely, the accounts and methods and practices of fire-insurance companies from that viewpoint.

Premiums, of course, are the principal item of income. In "non-agency" companies, of which there are several in Rhode Island, notably the so-called "factory mutuals", the most exact and perhaps the most satisfactory way is to check every premium from the policy copy books into the policy registers and verify the totals. Another check may be had by adding to the total outstanding or unpaid premiums at the beginning of any month, the total writings as shown on the face of the policy registers for that period, and deducting the cash received for premiums as shown in the cashbook. The difference should equal the unpaid premiums at the close of the month so verified, and thus prove the total writings. This process may be repeated for every month of the year, or it may be applied for the entire writings of the year.

In "agency" companies, where practically all the business is transacted through agents, the business is reported to the home office on what are commonly known as "daily reports". These reports, as they are received, are entered upon policy registers, usually by states and agencies, arranged alphabetically. The policy register should show the policy number, renewal number, name of agency, name of insured and location, the commencement and termination of the risk, the term, rate, the amount of insurance and the premium.

There is a wide variation in the methods followed in the several offices and the accountant should familiarize himself with the practice of the office whose accounts he is called upon to audit.

At the close of each month the amount of business transacted in each agency is summed up and carried to the record sheets and the total of such sheets is in turn posted to the premium account in the ledger.

At the close of each month, every agent is required to send his account to the home office. This is known as an account current, or monthly account, and is posted to what is commonly known as the agents' ledger.

It will be apparent that the total premiums entered upon the policy registers for a given period (after certain adjustments are made for policies written by the agents at the end of a given month but a report of which does not reach the home office until after the close thereof) will equal the total writings as reported by the agents.

Obviously, in a large company where many thousands of policies are written each month, it is not expected that every premium shall be checked by the auditor. I have found that a very good method is to take some of the larger agencies and to check thoroughly all of their writings for some given month, but taking the reports of each agency for a different month, endeavoring as far as possible to have a check of some one agency for each month of the period covered by the audit.

As in the case of the "non-agency" companies, a further check of this item may be secured by adding to the unpaid premiums at the beginning of a given period all premiums written during that period, and deducting therefrom the cash receipts credited to the item on the cashbook during that time. The difference should equal the unpaid premiums at the close of the period and thus prove that the total writings are correctly accounted for.

Cancellations.—Up to this point, no account has been taken of premiums which have been canceled by the agents through whose offices they were originally written, or by the company itself. Where return premiums are paid by such agents, which is usually the case, the total thereof may be verified from the monthly accounts. Then, too, every cancellation is immediately reported by the agent to the home office of the company and that fact is noted on the policy register in the account of the agent either in red or upon a separate sheet of a different colored paper. The totals of such cancellations so reported are of course to be deducted from the gross premiums written for we must bear in mind that, in a verification of the item of premiums, we are constantly charging the management with all writings and placing upon them the obligation of accounting for them. We must, therefore, give them credit for all cancellations, since they involve the return of the whole or some part of their writings. I say the whole or some part of the writings because there are two kinds of cancellations, viz., those where policies are canceled from date of issue, in which case the whole premium is returned or credited, and those where policies have been in force for some time and are then canceled, in which case only a part, that is, the unearned portion of the premium is returned.

Reinsurance.—Reinsurance is the process of ceding to another company of the whole or some part of the risk assumed. It is done in various ways. The more common is by way of what is known as a reinsurance agreement, whereby usually some fixed percentage of all risks of a certain class are automatically assumed by the reinsuring company. Another practice is to secure from some company a policy reinsuring some part of a particular risk. In either case, the auditor must ascertain the total of the premiums ceded in this way. In an isolated case, he may ask to be shown the policy covering the reinsurance and thus verify the amount of credit which the company which is being audited shall have. If under a contract for automatic reinsurance, then he should verify the entries which are made from time to time as reinsurance is effected upon what are known as "bordereaux sheets". Again, all items of reinsurance are usually entered in the policy register under the head of the agency which originally issued the policy so that a verification of the total credits in that agent's account will enable us to arrive at the aggregate of net premiums written during the period of the verification and the total of reinsurance effected.

Having ascertained the total premiums written, we then deduct from that total, on the income side of the statement, the sum of all premiums canceled and reinsured, and the result gives us the net premiums for which the management of the company must account.

Income from Investments, of course, will be found on the debit side of the cashbook. The auditor should secure from outside sources the rate of dividend paid upon the stocks listed in the company's assets during the period of the audit and the date when any dividends are declared. He should also learn the interest collectible upon bonds and other investments of the company, and with this information he may readily ascertain if all revenue from these sources has been properly accounted for.

In the annual statement blank prescribed by the insurance departments, allowance is made from income under this head for disbursements on account of accrued interest on securities purchased. The original vouchers on file in the company's office will reveal the total of such disbursements and of course the purchases made during the period will appear on record on the credit side of the cashbook, so that an absolute check of this particular item can be had.

Other Income.—The annual statement blank to which I have referred is so designed that in order to secure a total of income which, added to assets at the beginning of the period, less disbursements, will equal the ledger assets at the end of the period, all income must be entered under that head. So, in case a company disposes of any of its ledger assets, that is, its securities or property, which form a part of such assets, and realizes a profit from such sale, the amount of such profit is to be entered in income. Again, if a company mark up any of its property or securities, or in other words, increase the book value of any of its property which is a part of its ledger assets, the amount of such increase must likewise appear. It therefore becomes necessary in the course of an audit to ascertain what, if any, sales have been effected during the period covered, the book value of the thing sold at the time it is disposed of and the price at which it is sold. The excess of the sale price over its book value at the date of its sale is then to be carried under the head of income. On the other hand, if a loss results from such sale, the difference must appear in disbursements under the proper heading. Similarly, if the company increase the book value of any of its property during the period, the amount of such increase must appear in income. Such an item is of course easy of verification.

The item in the statement blank relating to profits from sales or maturity of ledger assets is entitled "profit on sale or maturity of ledger assets"; that for reporting increases in book values, or where assets are marked up is entitled "increase by adjustment in book values of ledger assets." Each item has subheads for (a) bonds, (b) stocks, (c) real estate, etc.

Having added to the above-mentioned items the income from all other sources, we now have the total for which the management must account, and we then proceed to verify the disbursements.

Disbursements

Losses.—It is a common rule among insurance company examiners and auditors, that every item of disbursements should be proved. It is a good rule to which to adhere. Bills, cheques, vouchers and other documents are available. They should be examined carefully. The item of losses is the most important on the disbursement side of the company's statement, and it follows that a corresponding amount of care should be exercised in its verification. As a rule the company records concerning this item are complete and are carefully kept. They usually consist of a loss register and loss files. The loss register gives the claim number, the policy number, the name of the insured, the date of the fire, the amount of the policy, the estimated loss and, when adjusted, the amount of the loss as adjusted, the amount paid, and the date of payment. As losses are paid, proper entries are made on the credit side of the cashbook, with sufficient details to enable one to trace the item back to the loss register.

Perhaps the most expeditious and at the same time the most satisfactory method of checking loss payments is to take the files of paid losses and to check items therewith into the loss register, comparing the amounts with the vouchers. I might add that in most cases at the present time losses are paid by draft, and the evidence of payment is usually found among the loss papers in the files. Having checked all drafts found in the paid files, with the entries in the loss register, it then becomes necessary to add the several items so checked, and a comparison of these with the totals in the cashbook will show whether all disbursements are properly accounted for or not. Naturally the question may be asked, "Why not check the vouchers for loss payments with entries corresponding thereto in the cashbook?" The best explanation is that the entries in the loss book are the original entries of these transactions, and then again, having checked the entries in the loss register to show the losses that have been paid, it is simple to verify unpaid losses at any given time by adding together all the outstanding losses or those which have not been checked in the process above outlined. Incurred losses are not a ledger liability. That is, as losses are reported to an insurance company, they are entered up in numerical order on a loss register, but the items appearing on the loss register never become a part of the entries in the company's ledger except as they are paid, and then the payments are posted from cashbook entries to the loss account in the ledger; but the loss account on the ledger is merely a record of the disbursements on account of losses and does not include the losses incurred and unpaid. The information secured by this check of the loss register is available to us then for arriving at the amounts of losses remaining unpaid which are to be carried under the head of liabilities in the statement. In some companies a "loss paid register" is kept, and to that book are carried each month all losses that have been settled during that period, but this is rather unusual, and as a rule the procedure above outlined is the one to be followed in verifying the payments on account of losses.

Commissions to Agents.—The commissions paid to agents for securing the business of the company are not uniform. Therefore no fixed rule can be laid down for the verification of this item. It can be checked, however, by reference to the monthly accounts of the agents. Records are available to show the rate of commission agreed upon between the company and any given agent on every class of business. Having ascertained this information, the auditor may then refer to that agent's monthly accounts, which he has already verified in arriving at the amount of premiums written, and proceed to check up commissions which the agent has claimed from the company in his statements to it. If it be incumbent upon the auditor to verify the total commissions paid over a given period, that process must be gone through with every agent. As this involves a great deal of detail work, it is not customary to make a seriatim check, but rather to rely upon the results secured in checking a number of the larger agencies of the company, or by taking accounts at random from the files and checking those as to their accuracy.

Salaries.—As a rule, companies secure from their officers and employees vouchers for salary payments. These vary in form. In some instances a salary-receipt book containing one page for receipts of all payments to a given employee for a year is used, while in others separate vouchers are required. In any event the sum total of the vouchers on file should of course equal the payments on account of this item. However, it is well that the auditor should know the rate of compensation of the employees so that he may be certain that no over-payments have been made and, if he finds that this has been done, to require a satisfactory explanation. Therefore the action of the board of directors in reference to salaries should be scrutinized from the records, and if there be any employees whose salaries are left in the discretion of the officers of the company, the auditor may require of the president or other officer a list of the employees and the salary paid to each.

Other Disbursements.—Little further need be said regarding the other items of disbursements commonly found in the accounts of insurance companies. There are taxes, office rent and office expenses, all of which may be proved with vouchers which the companies are usually careful to have on file. Of late years the practice has grown up in some insurance offices of relying upon the use of voucher cheques, for the reason that in many instances experience has shown that some concerns neglect to return bills properly receipted, and much inconvenience may be involved in securing proper vouchers. The use of voucher cheques is recommended by insurance departments, and where that practice is adhered to, it is an easy matter to verify these miscellaneous items of disbursements.

I referred under the head of income to profits realized from the sale of ledger assets of the company. Under the form of statement blank that is used, and upon which I am basing my analysis of insurance accounts, there must be a corresponding item to take care of losses sustained in similar transactions, and so one will find in the disbursement page of the statement blank an item reading "loss on sale or maturity of ledger assets." The amount to be entered opposite this item represents the difference between the value of the property on the books of the company at the time of its sale, less the price realized from the sale, or the loss. In order to arrive at this figure, it is necessary to ascertain from cashbook entries all items representing sales, usually of securities, of which a list should be prepared. Then by reference to the ledger cards or other records one should ascertain the book value of the items sold, and place this in a column parallel with one showing the sale price. Adding the two columns and deducting one from the other will give the result sought. Care should be taken, however, in the preparation of this schedule, so that items of securities sold at a profit may not be included here, because the corresponding item in income would then be erroneous, as it would not show the total profits realized; also, this item in disbursements would not be correct because it would not state correctly the exact amount of loss. In other words, gross profits from sales of assets should appear in income, and gross losses should appear in disbursements.

You will find on the disbursement side of the statement another item entitled "decrease by adjustment in book value of ledger assets". Opposite this item should be another of amounts charged off from book values of the property of the company, whether of investments or of furniture and fixtures or of real estate, or any other of its resources that are a ledger asset. These decreases will be found entered on individual ledger cards of the items of investments, or in the absence of these, in the ledger accounts.

Having gone through the whole list of disbursements, the sum of these, deducted from the income as previously ascertained, plus the total of the ledger assets at the beginning of the period, should give us the amount of the ledger assets at the end of the period.

Ledger Assets

It will be found that the main items of resources of fire-insurance companies consist of real estate, bonds and stocks, cash on hand and in banks and unpaid premiums. These I shall treat in the order in which they are noted above.

Real Estate.—It is the custom among insurance-department examiners to look carefully into the item real estate in assets of companies. Title deeds are examined, and in some instances the real-estate records of the town or city where the property is located are searched. Moreover, in the course of some examinations appraisers are appointed by the department to place a valuation upon the property. In the course of an audit, however, none of these steps is deemed necessary. They are never taken unless at the specific instance of the management of the company. It is assumed for the purposes of an audit that the value of the real estate as it is carried on the books of the company is correct, but in the auditor's report care should be taken to make it clear that no valuation has been had nor has any examination been made of the deeds or of the records.

Bonds and Stocks.—Most company officials require that the auditor check the items of bonds and stocks, and that he certify that this has been done. The usual practice is for the auditor to go to the safe-deposit vaults in company with the audit committee previously appointed, and together examine and check all securities found there. Before proceeding to the checking of the securities, I cause a list to be prepared showing the several items thereof as they appear on the books of the company, with one column showing their par value, and another column showing their book value. In the case of stocks, there is an additional column showing the number of shares owned. Having found all of the items appearing on my list, I then compare the total of the column of book values with the like total in the company's accounts.

There are some very clear and simple methods of verifying the accuracy of this account, among them the following: Ascertain the aggregate book value of the bonds and stocks owned by the company at the beginning of the period; to this add total purchases made during the year at cost. From this sum deduct the amount realized from the sales of securities, plus any loss sustained from such sales and minus any profit derived. Next, deduct all decreases from book values effected during the period and add all increases to such book values. The result should be the aggregate book value at the close of the period. In these various steps it will be found that reliance can be placed upon items under the headings of receipts and disbursements already verified. In the back part of the statement blank is to be found a number of schedules, among them one for the listing of bonds and stocks. This is known as schedule D. It is divided into four parts: part I, showing all bonds owned by the company at the close of the year; part II, all stocks owned by the company at the close of the year; part III, all bonds and stocks acquired during the current year, and part IV, all bonds and stocks disposed of during the year. These schedules give the book value, the par value and the market value. Also they contain data for obtaining verification of the prices at which secrrities are purchased and sold. It is on the basis of the information contained in these schedules that the formula above outlined is made up.

Deposits in Bank.—My practice is to verify all bank balances month by month with the original statements furnished the companies by the banks, and with the canceled cheques, and to reconcile the company balances with those credited by the banks in the usual way. I require a certificate from the bank of deposit showing its balance at the close of the period covered by the audit, and this balance is then reconciled with the company's balance.

In the verification of the item of cash, it is the practice among many auditors and likewise among insurance department examiners, to count the cash upon entering the office. My practice has aways been to defer this verification until the other items of assets have been verified, and if I happen to do this at a time subsequent to the date when I wish to ascertain the cash balance on hand, I merely check back through receipts and disbursements until I prove that the balance on hand as reported at the date on which I wish it verified, plus accretions thereto, less disbursements therefrom, gives the balance at the time of verification. This procedure is not claimed to be of any particular advantage over other methods, but it does proceed in a different way from that followed in making up the accounts, and that course is to be followed in an audit in every instance where possible. As a rule, however, in fire-insurance companies this is a minor item, as most of the funds are deposited in banks and are subject to disbursement by cheque. In fact in some companies not one cent is disbursed otherwise than by cheque, and in my experience I have found this to be a salutary rule which I never hesitate to recommend wherever it is possible to put it into effect.

Unpaid Premiums.—For a verification of unpaid premiums we can have recourse, in the case of "agency" companies, to the monthly reports of the agents, either checking all reports for the period of the audit and summarizing all commissions that are unpaid upon the business so reported, or we may limit our investigation to applying test checks, choosing for the purpose some few agencies scattered about the country, or picking them out at random from the report files.

It must be remembered that the whole structure of insurance is based upon the law of averages, and the theory is that as the law of averages works out in the management of the business of insurance, so as a rule it will be found to work out in the verification of their accounts. At any rate such is the theory, but like the artist who, when asked how he mixed his paints replied that he mixed them with brains, the auditor should, in his application of such checks, be ever mindful of the fact that the quality of his work will always be improved by such a mixture. It is a business involving almost endless detail. It requires the making of many thousands of entries of various kinds; the keeping of many data; the preparation of schedules, and the making of many calculations. All these steps are necessary, not only for the information of the officials of the company to enable them to know as nearly as possible the state of their business and how best to construct their rates for insurance, but also to comply with the requirements of the laws of the several states and of their insurance departments. To go into every detail of these records would be a considerable task, and would require the services of a large force of auditors to be constantly available. This would not only entail great expense, but would interfere in some measure with the ordinary work of the company's office, because records and books of account would at some time or other be always under scrutiny of some one of the auditors. Therefore it has been the common practice, both among department examiners and company auditors, to resort to this rule of applying test checks and basing findings upon the law of averages.

In ascertaining the total premiums unpaid at a given period, we have, however, a rather definite starting point. Adding to the premiums unpaid at the beginning of the period the total premiums written during that time as shown in the policy registers, which we have already verified, and deducting from that sum the cash received on this account, as shown by cashbook entries and as verified by reference to the monthly accounts of the agents, we should have as the difference the premiums unpaid at the close of the period.

In non-agency companies, the item of unpaid premiums can be absolutely determined, because all policies are written at the home office, and all premiums are received there, so that missing agents' accounts do not interfere with the work. The policy registers, the items of which have all been verified by the auditor in the course of his work, will show opposite each item therein the date when premiums have been paid, so that if we proceed to examine those registers and list the premiums which are not marked as having been paid, or have been paid subsequent to the last day of the period covered by the audit, the sum of these will be the amount necessary to make up our balance of ledger assets. To prove this in another way, add to the premiums written during the period those that were unpaid at the beginning thereof, and deduct from the sum the entries appearing in the cash book and representing premium payments during the same time. The difference will produce the like result.

The above item of assets, together with such other miscellaneous items, though perhaps of a minor nature, as may be found on the face of the ledger, when added together, should equal the balance remaining after disbursements are deducted from the sum of the ledger assets at the beginning of the period plus the income as ascertained. If this be not the result, then the fault is in the auditor or the accounts are incorrect.

Non-Ledger Assets

In addition to the assets referred to above, the statement blank shows certain items of assets under the heading "non-ledger assets." Among these may be mentioned interest due and accrued on bonds and stocks and on mortgages and collateral loans; also the excess of market value of securites owned by the company over the values as they are carried upon its books. While the auditor is usually not called upon to verify any of these items, he may be asked for the information, inasmuch as it is required by the supervising officials in the various insurance departments, and therefore he should be prepared to ascertain proper answers to those questions, and in fact it is well that in the preparation of his report he should include such answers in his statement.

The various items of interest due and accrued may be calculated from information appearing upon the schedules to which I have referred. These schedules will show, among other things, the rate of interest or dividend on bonds or stocks and when payable, so that in order to arrive at the amount of interest due or accrued upon any given item of securities, it is necessary only to apply that rate of interest or dividend to the par value of the security for the period of time which has elasped since the last interest payment, up to the last day of the period covered by the audit.

In arriving at the excess of the market value of bonds and stocks over their book value, the auditor has an infallible guide. The market values of all securities owned by the insurance companies at the close of each year are fixed by a committee of the National Convention of Insurance Commissioners, and in arriving at the surplus of an insurance company, no other values are recognized. Therefore, this gives us a definite starting point, so that the aggregate of the values on this basis, minus the aggregate values appearing on the books of a company, is the answer to this question in the financial statement, provided, of course, that these market values are the greater.

Non-Admitted Assets

The department statement blank also contains a provision for listing those assets which are disallowed, either by law in some states, or by rulings of the insurance commissioners in others. They appear under the head "non-admitted assets". They consist in the main of unpaid premiums written more than three months prior to the date of the statement, excess of book value of securities over their market value, and other items which need no extended comment.

We have seen that under the head of non-ledger assets, departments allow a credit to companies for the excess of the market value of securities over their book value. Under the present heading, they disallow the excess of the book value of companies' securities over their market value as fixed in the manner hereinbefore outlined. I realize that these items of non-ledger assets and non-admitted assets are not book assets, and yet insurance companies have to deal with them in the preparation of their annual statements. Those statements must be sworn to, and it behooves the auditor of insurance accounts to see that the items appearing therein are correct. Moreover, they are the basis of calculating the company's surplus fund, as it appears in the financial reports which are usually published for advertising purposes, as well as in official publications. Therefore, it is the duty of the auditor of an insurance company to continue his investigation so as to include this part of the company's report.

Having taken into account all items of receipts and disbursements, if the work has been correctly done and the books are in balance, then the ledger assets which we have listed under the proper head, plus those items just referred to, and minus those that are disallowed, will give what in the statement are termed "admitted assets".

We next proceed to the verification of the company's liabilities.

LIABILITIES

Losses.—From the unpaid-loss register, or from the loss register proper, if there be no such thing as an unpaid-loss register, or from the unpaid-loss files, the amount of unpaid losses as of the date of the audit is to be determined. We have already seen in our discussion of the item of losses paid, under the head of disbursements, that a check has been made of this register to ascertain the amount actually disbursed on this account during the period covered by the audit, and it was there noted that the unchecked items appearing in that record would give us the amount of the unpaid losses for the purpose of computing the liabilities of the company. The total sum of the losses entered in the loss register, and unchecked with vouchers supporting payments, will give us the gross outstanding or unpaid losses, but there is an element which we have not discussed up to the present time, either under this head or under the head of disbursements in our treatment of losses, which I now desire to call to attention. That is the outstanding reinsurance on risks where losses have occurred. It must be clear that where a company assumes a risk of, say, $10,000, and reinsures fifty per cent. of it, for which it pays to the reinsuring company fifty per cent. of the premium, if a loss accrue thereon, whatever it may be, the reinsuring company is liable and must answer to the ceding company for fifty per cent. of it; and so in an estimate of this item it is necessary to ascertain just what risks have been reinsured in order that one may make proper deduction from the gross losses to ascertain the exact amount that must be set up as a liability against the company which is being audited. Of course, if the loss has already been paid, and the auditor finds that the reinsurance has not been collected, he should give credit under the head of non-ledger assets for whatever amount he finds due. I might say, in passing, that the item with which we are now concerned, namely, unpaid losses, is never a ledger liability. It is made up of losses in two different conditions; first, those that are adjusted and for which the company must assume a liability equal to the amount of the adjustment, and, second, those that are unadjusted, in which case the company is charged with a liability equal to the estimate given in the report of the loss originally filed in the office of the company. It is important, in the treatment of unadjusted losses, to ascertain whether or not the estimates are ample to cover any prospective liability, and so these can be verified by going back for any given period of time, or for a short time in each of three, four or five years, comparing the estimates of losses sustained with the actual adjustment figures. If it be found that on the average or in the majority of cases the estimates exceed the adjusted figures, it is fair to assume a liability equal to the total of those estimates. If, however, we find that in a majority of instances the estimates fall short of the adjusted figure, my practice has been to add to the estimates a percentage equal to that by which I find the estimates have been underestimated. In other words, if upon an examination of the estimates I find they have been understated to the extent of ten per cent., I add that percentage to the amount of estimated losses which form a part of the liabilities of the company.

Unearned-premium Reserve.—The unearned-premium reserve is commonly looked upon as a fund sufficient to reinsure all the outstanding risks of a company at any given time. As required to be computed and carried as a liability, this has generally been found to be the case where a company is wound up either through liquidation or receivership proceedings. The better reason for its existence, however, is found in the provisions of fire-insurance-company contracts. In most states fire-insurance companies are prohibited by statute from issuing policies of insurance in any other than the standard forms prescribed. In all these forms there is a provision that the policy may be canceled at any time at the request of the assured, and in that case the company is under obligation to return to the assured a proportion of the premium originally paid, usually on a basis known as a "short rate" and dependent upon the length of time the policy has been in force. Such contracts also provide that the company may cancel at any time, and when cancellation is effected at the instance of the company the policy holder is entitled to receive the unearned portion of his premium on what is known as the prorata basis, also dependent upon the length of time the policy has been in force. These reinsurance or unearned-premium reserves are prescribed by statute in some states, but every insurance department requires them to be carried as a liability, and so uniform is this requirement that the proportion of the premiums in force to be charged as a reserve in liabilities is made a part of the statement blank.

The calculation of reserves on outstanding premiums is not difficult, though it does involve the consideration of many items. It may be summarized in the following brief statement: Charge every company with a liability for unearned premiums on all risks written for one year or less equal to one-half of the premiums written in the policy in force. In policies for longer terms, the unearned-premium or reinsurance reserve is calculated to be one half of the premium for the current year, and the full premium for the remaining years.

Let us assume, to illustrate, that the premium on a policy running five years is $100 or $20 per annum. Charging the policy with $20 per annum for four years would give us $80, and one-half of the first year's premium of $20, or $10, would make the total reserve $90, or nine-tenths of the premium. On a five-year policy which has run for one year, the unearned proportion of the premium would be seven-tenths, and so on, until when a five-year policy has been in force four years, there is but one-tenth of the premium carried as a reserve under the head of liabilities.

To make a complete computation of the reserves upon all of the policies of the company would be an almost interminable task. I remember in one instance, where the department in which I was employed did do this, and with three men engaged in the work, it took them something over three months to arrive at a figure. Of course the larger the company and the more policies it has in force, the greater the task. In this phase of the work of an audit, as well as in others, the law of averages can be relied upon in ordinary cases, and in cases that are not ordinary, there is no fixed rule to be laid down. I have found, upon an examination of reserve figures of as many as two hundred companies for a given year, that the total reserves upon all of the business for all terms varies not much from around fifty-two per cent. to fifty-five per cent. That is to say, one will find that the reserves, calculated in accordance with the rule above outlined, always having regard to the length of term for which the policy is written, will in the aggregate equal about from fifty to fifty-five per cent. of the total premiums in force, regardless of terms.

As in the verification of other items, it is possible to block off the writings of a given month for a given term, and trace those into the reserve register. This can be repeated as many times as is deemed necessary, until the auditor is satisfied that the reserve figures carried in the company's statement are probably correct and must be approximately so.

Other Liabilities.—Besides the above large items of liabilities, there will be found items of unpaid commissions and unpaid taxes, and unpaid bills of all kinds. In arriving at the amount of unpaid commissions, the auditor can at least approximate the liability by finding the proportion which the commissions paid during a given period bears to the premiums received during that period, and apply that factor, so ascertained, to the premiums remaining unpaid and reported in assets in the statement. Likewise in estimating unpaid taxes, it will be found that in the main all taxes paid during a given year are computed upon the business of the company transacted during the preceding year. Therefore the auditor has but to ascertain what percentage of the premiums of the preceding period, preferably a year, has been paid for taxes during the current year; then apply that factor to the business of the current year, and the result will be the unpaid taxes to be carried in liabilities. This is, of course, subject to some modifications, as for example, where taxes are payable quarterly or semi-annually in some states, and in those instances proper allowance should be made.

Having ascertained the total liabilities of the company, the difference between that figure and the total admitted assets will be set down as the surplus of the company, if a mutual company, and if a stock company, then the liability sheet will read about as follows:

Total liabilities except capital		———
Capital paid up	———	
Surplus over all liabilities	———	
Surplus as regards policy holders		———
Total		———

These two items of capital and surplus, added to liabilities as already computed, should equal the amount of the admitted assets on the other side of the statement.