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Accounting Questions: Accounting for Insurance Claims

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ACCOUNTING QUESTIONS

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ACCOUNTING FOR INSURANCE CLAIMS

Question

A company engaged in the marine towing business and closing its books at December 31st each year has previously carried marine liability insurance up to the value of each tug boat. The policies for this insurance provide that the first $500 of each damage claim known as deductible average shall be borne by the company, and it has been the company's policy in closing its accounts each year to provide a reserve for this deductible average on every accident occurring during the period under review. The amount of the deductible average to be borne by the company on each accident has naturally varied with the insurance premium paid and the type of policy deemed to be most advantageous to the company.

At the expiration of the old policies on August 1, 1937, renewal policies were purchased which provided, in effect, that the company would bear, in addition to the deductible average of $500 for each accident, the first $40,000 of losses on all accidents occurring during the policy year. The premium on the new policy was consequently less than that paid in prior years. When the new policy was taken out, the company, in order to satisfy the mortgagees of the equipment, considered the covering of its possible loss of $40,000 through an underwriting syndicate, whereby it would have been necessary for the company to deposit $40,000 with the syndicate with an additional cost of $2,200 to cover overhead expenses of the syndicate. The mortgagees of the equipment subsequently permitted the company to assume the liability for the $40,000 without reinsurance through a syndicate.

As at December 31, 1937, the books of the company indicate that entries have been made from August 1st to December 31st by charging damage claims expense and crediting the reserve for damage claims in the amount of 5/12 of the $40,000, or $16,667. (Entries have also been made to give effect to the deductible average loss according to past practice.) An examination of the open claims pending at December 31, 1937, indicates that there are $45,000 of claims chargeable against the $40,000 of losses to be assumed by the company. However, since these claims have not been settled, the exact amount of the liability is not known.

In preparing the balance-sheet as at December 31, 1937, these questions arise:

1. Since the company is, in effect, carrying its own insurance to the extent of $40,000 (although no cash reserve has been provided) is it permissible to show as a reserve for damage claims only 5/12 of $40,000 which has been reserved to December 31, 1937, in as much as the maximum loss to be borne by the company during the policy year will be $40,000, even though accidents have happened during the period under review which undoubtedly will be settled for an amount in excess of the reserve at December 31, 1937?
2. Assuming that the reserve at December 31, 1937, amounts to $16,667, or 5/12 of the total maximum loss to be borne during the policy year, and accident claims amounting to $30,000 have actually been settled by the claims department during this period, is it permissible to show as a deferred charge on the balance-sheet at December 31, 1937, $13,333 which will be

amortized over the balance of the policy year, or must the reserve be increased to $30,000 to cover accidents settled, by a charge to the expense account, since the loss has actually occurred during the period under review?

3. In case it is considered better accounting practice to create a reserve of $40,000 by a charge to deferred charges at the beginning of the policy year against which reserve actual losses are recorded, the deferred charge being amortized over the policy year, then in case the expense on settled cases to December 31st exceeds the amount amortized, should the deferred charge be reduced by a charge to expense or may the excess of the losses incurred over the amount amortized be amortized over the remaining policy year?

Answer No. 1

In general, the operations for the year 1937 should be charged with all expenses or losses incurred during the year. Claims amounting to $30,000 were actually settled by the claims department, but apparently the exact amount of the liability at December 31, 1937, for other claims, not settled, is not known. Under these circumstances, operations for 1937 should be charged with $30,000, plus an amount which appears sufficient to cover the probable liability for the unsettled claims. If a reserve is provided for $40,000, only the excess, if any, of this amount over the estimated liability for claims in 1937 should be shown as a deferred charge in the balance-sheet at December 31, 1937.

Answer No. 2

It seems to me that the showing of a reserve for only $\frac{5}{12}$ of $40,000 at December 31, 1937, would be inadequate for the reason that a definite and probably payable risk of $40,000 was assumed by the company on August 1, 1937, and that a reserve for the full amount thereof should have been established at that date by the setting up of a deferred charge to be amortized over the policy year.

This partially disposes of the second question, for it seems to me the $30,000 of damage claims actually settled between August 1st and December 31st should be charged against the reserve leaving a balance of $10,000 therein at December 31st. Although the loss actually occurred during the five-month period, it is nevertheless a part of the loss which will not exceed $40,000 for the policy year and I would consider it proper that the deferred charge should be shown on the balance-sheet at December 31st in an amount equal to $\frac{7}{12}$ of the original $40,000.

I think that the two foregoing paragraphs answer the third question.

Answer No. 3

In our opinion, the best accounting under the policy of self-insurance to the extent of $40,000 requires the establishment of a reserve in that amount at the beginning of the policy year with a contra debit to deferred charges to be amortized ratably over the policy year. Against this reserve would be charged the first $40,000 of losses arising from settlements of accident claims of that year. The deferred charge to operations need not be accelerated in the event that losses to a given date exceed (a) the total amount of losses to be borne by the insured or (b) the amount of such deferred charge absorbed in operations. Answering specific questions:

1. We do not believe it desirable to carry a reserve for damage claims amounting to only $\frac{5}{12}$ of $40,000 at December 31, 1937, when damage claims have already been received which "undoubtedly will be settled for an amount in excess of the reserve."
2. We do not believe the suggested procedure is entirely satisfactory. We believe that at this date the deferred charge should be $23,333.33.
3. As stated on the preceding page, the reserve is created to absorb the losses not in excess of $40,000 for one year. The debit to deferred charge is an accounting device for spreading to cost of self-insurance proportionately over the policy year. The write-off of the deferred charge need not be accelerated in the event that losses to a given date exceed the amortization of such deferred charge to the same date.