Background on: Insurance accounting

Insurance Industry

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Overview

Accounting is a system of recording, analyzing and reporting an organization's financial status. In the United States, all corporate accounting and reporting is governed by a common set of standards, known as generally accepted accounting principles, or GAAP, established by the independent Financial Accounting Standards Board (FASB).

In 2001 the International Accounting Standards Board (IASB), an independent international accounting organization based in London, began work on a set of global accounting standards called International Accounting Standards and International Financial Reporting Standards (collectively IFRS). About the same time, the European Union (EU) started work on Solvency II, a framework directive aimed at streamlining and strengthening solvency requirements across the EU in an effort to create a single market for insurance. Ideally, a set of universal accounting principles would facilitate global capital flows and lower the cost of raising capital. Some 100 countries now require or allow the international standards that the IASB has developed.

The Securities and Exchange Commission (SEC) requires companies that file financial statements with them to follow GAAP or IFRS depending on whether they are U.S. issuers or foreign private issuers. Over time, the FASB has evaluated and to some extent aligned their standards with International Financial Reporting Standards (IFRS) through a joint project or have decided to in other cases to not align them.

Accounting standards have evolved over time and for different users. Before the 1930s corporate accounting and reporting focused on management and creditors as the end users. Since then GAAP has increasingly addressed investors' need to be able to evaluate and compare financial performance from one reporting period to the next and among companies. In addition, GAAP has emphasized "transparency," meaning that financial statements and reports must be understandable by knowledgeable people and the information included in financial statements must be reliable and companies must fully disclose all relevant and significant information.

Special accounting standards also evolved for industries with a fiduciary responsibility to the public such as banks and insurance companies. To protect insurance company policyholders, state insurance regulators began to monitor insurance company solvency. As they did, a special insurance accounting standards, known as statutory accounting principles and practices, or SAP, developed. The term *statutory* accounting denotes the fact that SAP embodies practices prescribed or permitted by state law. SAP provides the same type of information about an insurer's financial performance as GAAP but, since its primary goal is to provide information about an insurance company's solvency, it focuses more on the valuation and admissibility of assets and measurement of liabilities on balance sheet using more conservative criteria than GAAP.

Publicly owned U.S. insurance companies, like companies in any other type of business, report to the SEC using GAAP. However, they report to insurance regulators and pay taxes using SAP. Accounting principles and practices outside the U.S. differ from both GAAP and SAP.

Insurance contracts

With the issuance of IFRS 17, the accounting standard for insurance products issued by the IASB and FASB's decision to provided targeted improvements to GAAP, as opposed to remaining in the joint project with the IASB to converge insurance accounting standards. It appears unlikely that the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standard Board (IASB) will be able to achieve a convergence of the two systems with regard to property/casualty insurance in the foreseeable future. Some insurers have been concerned that some of the initially proposed standards for insurance contracts will confuse more than enlighten and introduce a significant level of artificial volatility that could make investing in insurance companies less attractive

FASB decided to focus on improving U.S. GAAP. For short-duration contracts–which includes most property/casualty insurance—FASB targeted changes that enhance disclosures. For long-duration contracts like life insurance, the board concluded it would pursue target improvements to traditional long-duration contracts:

- By requiring assumptions to be updated annually, as opposed to locked-in a contract inception
- Identifying product features, called Market Risk Benefit, which will be recorded at fair value
- Simplify deferred policy acquisition cost amortization
- Significantly enhance disclosures related to contract liabilities and assumptions.

Insurance basics

Insurers assume and manage risk in return for a premium. The premium for each policy, or contract, is calculated based in part on historical data aggregated from many similar policies and is paid in advance of the delivery of the protection. The actual cost of each policy to the insurer is not known until the end of the policy period (or for some insurance products long after the end of the policy period), when the cost of claims can be calculated with finality.

The insurance industry is divided into two major segments: property/casualty, also known as general insurance or nonlife, particularly outside the United States, and life/health. Broadly speaking, property/casualty policies cover homes, autos and businesses; life/health insurers sell life, long-term care and disability insurance, annuities and health insurance. U.S. insurers submit financial statements to state regulators using statutory accounting principles, but there are significant differences between the accounting practices of property/casualty and life insurers due to the nature of their products. These include:

- **Contract duration**: Property/casualty insurance policies are usually short-term contracts, six-months to a year. Their final cost will usually be known within a year or so after the policy term begins, except for some types of liability contracts. They are known as short-duration contracts. By contrast, life, disability and long-term care insurance and annuity contracts are typically long-duration contracts—in force for decades.
- **Variability of Claims Outcomes Per Year**: The range of potential outcomes with property/casualty insurance contracts can vary widely, depending on whether claims are made under the policy, and if so, how much each claim ultimately settles for. The cost of investigating a claim can also vary. In some years, natural disasters such as hurricanes and man-made disasters such as terrorist attacks can produce huge numbers of claims. By contrast, claims against life insurance and annuity contracts are typically amounts stated in the

contracts and are therefore more predictable, for example mortality in a life contract. There are few instances of catastrophic losses in the life insurance industry comparable to those in the property/casualty insurance industry.

Financial statements

An insurance company's annual financial statement is a lengthy and detailed document that shows all aspects of its business. In statutory accounting, the initial section includes a balance sheet, an income statement and a section known as the Capital and Surplus Account, which sets out the major components of policyholders' surplus and changes in the account during the year. As with GAAP accounting, the balance sheet presents a picture of a company's financial position at one moment in time—its assets and its liabilities—and the income statement provides a record of the company's operating results from the previous period. An insurance company's policyholders' surplus—its assets minus its liabilities—serves as the company's financial cushion against catastrophic losses and as a way to fund expansion. Regulators require insurers to have sufficient surplus to support the policies they issue. The greater the risks assumed, and hence the greater the potential for claims against the policy, the higher the amount of policyholders' surplus required.

Asset valuation

Property/casualty companies need to be able to pay claims promptly and also to raise cash quickly to pay for a large number of claims in case of a hurricane or other disaster. Therefore, most of their assets are high quality, income-paying government and corporate bonds that are generally held to maturity. Under SAP, they are valued at amortized cost rather than their current market cost. This produces a relatively stable bond asset value from year to year (and reflects the expected use of the asset.)

However, when prevailing interest rates are higher than bonds' coupon rates, amortized cost overstates asset value, producing a higher value than one based on the market. (Under the amortized cost method, the difference between the cost of a bond at the date of purchase and its face value at maturity is accounted for on the balance sheet by gradually changing the bond's value. This entails increasing its value from the purchase price when the bond was bought at a discount and decreasing it when the bond was bought at a premium.) Under GAAP, bonds may be valued at market price or recorded at amortized cost, depending on whether the insurer plans to hold them to maturity (amortized cost) or make them available for sale or active trading (market value).

The second largest asset category for property/casualty companies, preferred and common stocks, is valued at market price. Life insurance companies generally hold a small percentage of their assets in preferred or common stock.

Some assets are "nonadmitted" under SAP and therefore assigned a zero value but are included under GAAP. Examples are premiums overdue by 90 days and office furniture. Real estate and mortgages make up a small fraction of a property/casualty company's assets because they are relatively illiquid. Life insurance companies, whose liabilities are longer term commitments, have a greater portion of their investments in residential and commercial mortgages.

The last major asset category is reinsurance recoverables. These are amounts due from the company's reinsurers. (Reinsurers are insurance companies that insure other insurance companies, thus sharing the risk of loss.) Amounts due from reinsurance companies are categorized according to whether they are overdue and, if so, by how many days. Those recoverables deemed uncollectible are reported as a surplus penalty on the liability side of the balance sheet, thus reducing surplus.

Liabilities and reserves

Liabilities, or claims against assets, are divided into two components: reserves for obligations to policyholders and claims by other creditors. Reserves for an insurer's obligations to its policyholders are by far the largest liability. Property/casualty insurers have three types of reserve: unearned premium reserves, or liability for unexpired insurance coverage; loss and loss adjustment reserves, or post claims liability; and other.

Unearned premiums are the portion of the premium that corresponds to the unexpired part of the policy period. Premiums have not been fully "earned" by the insurance company until the policy expires. In theory, the unearned premium reserve represents the amount that the company would owe all its policyholders for coverage not yet provided if one day the company suddenly went out of business or the policyholders cancel coverage. If a policy is canceled before it expires, part of the original premium payment must be returned to the policyholder.

Loss reserves are obligations that an insurance company has incurred—from claims that have been or will be filed on the exposures the insurer protected. Loss adjustment reserves are reserves set aside to pay for claims adjusters, legal assistance, investigators and other expenses associated with settling claims. Property/casualty insurers set up claim reserves only for accidents and other events that have happened.

Some claims, like fire losses, are easily estimated and quickly settled. But others, such as products liability and some workers compensation claims, may be settled long after the policy has expired. The most difficult to assess are loss reserves for events that have already happened but have not been reported to the insurance company, known as "incurred but not reported" (IBNR). Examples of IBNR losses are cases where workers inhaled asbestos fibers but did not file a claim until their illness was diagnosed 20 or 30 years later. Actuarial estimates of the amounts that will be paid on outstanding claims must be made so that profit on the business can be calculated. Insurers estimate claims costs, including IBNR claims, based on their experience. Reserves are adjusted, with a corresponding impact on earnings, in subsequent years as each case develops and more details become known.

Revenues, expenses and profits

Profits arise from insurance company operations (underwriting results) and investment results.

Policyholder premiums are an insurer's main revenue source. Under SAP, when a property/casualty policy is issued, the unearned premium is equal to the written premium. (Written premiums are the premiums charged for coverage under policies written regardless of whether they have been collected or "earned." Each day the policy remains in force, one day of unearned premium is earned, and the unearned premium is reduced by the amount earned. For example, if a customer pays $365 for a one-year policy starting January 1, the initial unearned premium reserve would be $365, and the earned premium would be $0. After one day, the unearned premium reserve would be $364, and the earned premium would be $1.

Under GAAP, policy acquisition expenses, such as agent commissions, are deferred and expensed on a ratable basis generally in line with earning of premiums. As a result, under GAAP (and assuming losses and other expenses are experienced as contemplated in the rate applied to calculate the premium) profit is generated steadily throughout the duration of the contract. In contrast, under SAP expenses associated with the acquisition of the policy are recognized as an expense as soon as the policy is issued but premiums are earned throughout the policy period.

By recognizing acquisition expenses before the premium income is fully earned, an insurance company is required to absorb those expenses in its policyholders' surplus. This appears to reduce the surplus available at the inception of a policy to pay unexpected claims under that policy. In effect, surplus calculated this accounting system requires an insurer to have a larger safety margin in its policyholder surplus levels to be able to fulfill its obligation to those policyholders.

Additional resources:

- The accounting firm of Deloitte publishes IASPlus, which covers global accounting news, including changes affecting the insurance industry.
- A section of the International Accounting Standards Board website focuses on insurance accounting, particularly the FASB and IASB projects.

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