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American Institute of Certified Public Accountants

INDUSTRY AUDIT GUIDE

AUDITS OF FIRE AND CASUALTY INSURANCE COMPANIES

PREPARED BY THE COMMITTEE ON INSURANCE ACCOUNTING AND AUDITING

Third Edition

Including
STATEMENTS OF POSITION
ISSUED BY THE ACCOUNTING AND AUDITING STANDARDS DIVISIONS

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American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, N.Y. 10036

Note: This volume includes the industry audit guide, *Audits of Fire and Casualty Insurance Companies,* as it was originally published in 1966; the statement of position, *Revision of Form of Auditor's Report: Audits of Fire and Casualty Insurance Companies,* issued by the auditing standards division in 1974; and Statement of Position 78-6, *Accounting for Property and Liability Insurance Companies,* issued by the accounting standards division in 1978. In using this guide, readers should refer to the additional material in the statements of position (pages 79-114), which was not available when the guide was issued.

Douglas R. Carmichael
Vice President—Auditing

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NOTICE TO READERS

This bulletin is published for the information and assistance of members of the Institute and others interested in the subject. It presents the view of the members of the 1965-66 committee on insurance accounting and auditing. Since it has not been considered and acted upon by the Council of the Institute, it does not represent an official position of the Institute.

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Preface

This booklet has been prepared for the purpose of broadening the knowledge of the independent auditor regarding those aspects of the fire and casualty insurance business which he should be aware of in order to most effectively serve his clients in that industry.

The material contained in this booklet covers such matters as the nature of the business and how it is conducted; the character and extent of regulation and its effect upon company policies and practices; the methods and mechanics of accounting and record keeping for major types of transactions and classifications of accounts; the prescribed financial reporting principles and practices and their variances from generally accepted accounting principles for business in general; basic forms of financial statements; and the independent auditor's report.

The booklet includes suggested auditing procedures designed to provide a pattern of the work to be done; they are, therefore, very general in nature and will not apply in the same degree to all situations. The program for each audit should be designed to meet the requirements of the particular situation, giving careful consideration to the size, the type of organization and the adequacy of the existing system of internal control.

Committee on Insurance Accounting and Auditing

July 1966

Chapter I

Audits of Fire and Casualty Insurance Companies

NATURE AND CONDUCT OF BUSINESS

General Nature of the Business

The primary purpose of the fire and casualty insurance business is spreading of risks. For a consideration known as a premium, insurance companies undertake to relieve the policyholder of a risk and to spread the total cost of similar risks among large groups of policyholders. The fire and casualty insurance business includes the sale of insurance, the underwriting operation (i.e., the determination of the acceptability of the risk and the premium), the collection of premiums and investigation and settlement of claims made under the policies issued.

In the process of conducting its business an insurance company accumulates large sums of money. These funds represent an accumulation of premiums collected in advance for periods, generally for one to five years, and sums held for the payment of claims in process of investigation, adjustment, or litigation. The possession of these funds leads to the second major operation, the investment of funds.

The hazards insured are generally grouped into what are known as lines of insurance, as follows: fire and allied lines, ocean and inland marine, commercial and homeowners multiple perils, accident and health, workmen's compensation, general

liability, automobile liability and physical damage, fidelity and surety, glass, burglary and theft, and boiler and machinery.

All of these lines of insurance may be written in the same company if it qualifies for multiple line writing of insurance.

Types of Organization

The following are the principal types of organization:

Stock companies:

A stock company is an ordinary corporation organized for profit; ownership of assets and control of operations are vested in the stockholders. Generally the stockholders are not liable in case of bankruptcy or impairment of capital.

Mutual companies:

A mutual company is an organization in which the ownership of assets and control of operations are vested in policyholders having ownership rights only as long as they continue being policyholders; upon the expiration of their policies, they lose all rights and interest in the company. In many states upon liquidation of a mutual insurance company, the net assets are distributed among the then policyholders of the company and the prior policyholders have no claim against such assets.

Many mutual companies issue nonassessable policies as provided under the various state laws, but in those instances where companies have not qualified to issue such policies, each policyholder is liable for an assessment equal to at least one annual premium in case of bankruptcy or impairment of minimum surplus requirements.

Reciprocal or Inter-insurance Exchanges:

A reciprocal exchange is composed of a group of persons, firms or corporations commonly termed "subscribers" who exchange contracts of insurance through the medium of an attorney-in-fact; each subscriber executes an agreement (usually called the subscriber's agreement), identical with that executed by every other subscriber, empowering the attorney-in-fact to assume on the subscriber's behalf an underwriting liability on policies covering the risks of the other subscribers. The subscriber assumes no liability as an underwriter on policies covering his own risk; his liability is several and not joint, and is limited by the terms of the subscriber's agreement. Customarily, the at-

torney-in-fact is compensated by payment of a percentage of premium income, out of which most operating expenses are paid; but a considerable number of exchanges pay their own operating expenses, and compensate the attorney-in-fact by a moderate percentage of premiums, or by some other method.

Methods of Producing Business

Companies acquire their business in different ways. The principal methods are as follows:

General agents:

General agents have an exclusive territory in which to produce business. They agree to promote the company interest, pay their own expenses, maintain a satisfactory agency force and secure subagents; they may do a good deal of the underwriting, and perform other services in connection with the issuance of policies and the adjustment of claims which neither local agents nor brokers are generally authorized or expected to do. General agents are compensated on the basis of a percentage of the premiums they produce. This percentage is higher than the percentage of the premium they pay to their local subagents whom they appoint or to the brokers from whom they secure business.

Local and regional agents:

Local and regional agents are authorized to write business, but are not usually given an exclusive territorial arrangement; they usually report either to company branch offices or directly to the home office and are generally compensated on the basis of a percentage of the premiums they produce, which is usually lower than the percentage allowed to a general agent.

Brokers:

Insurance brokers are "free lance agents" who solicit business and place it in different companies without a contractual relationship. They actually submit the business for acceptance or rejection directly to the company, through a general agency, local agents, or other brokers.

Direct writing:

Some companies, generally known as direct writing companies, sell their policies through either salaried or commissioned salesmen. Frequently this is done directly from the home office;

frequently it is conducted through sales branch offices. These employees only take the orders: underwriting and policywriting, etc., is done either in the branch offices or in the home office; salesmen generally do not have the power to bind the company on risks.

The distinction between an agent, a broker, and a salesman is based on their relationship to the insurance company. The agent, whether general or local, has the power to bind the company and is also an agent of the insured; he is an independent contractor in his relationship with the insurance company. Generally, the agent is considered to have a vested right in the renewal of policies he sells for the insurance company; the company cannot compel him to renew a policy if he prefers to place it with some other insurance company. The broker is an agent of the insured only. The salesman is an employee of the company and has no vested interest in the renewal of the policies for which he was initially responsible.

Methods of Adjusting Claims

The methods of investigation, adjustment and settlement of claims vary among companies. The more common methods are:
Adjustment bureaus:

An adjustment bureau is an organization established by a number of insurance companies who become members of the bureau and who refer to it for investigation and settlement some or all of their claims in some, or even all, territories. Subject to certain limitations, the adjustment bureau acts for each such company in the adjustment of and negotiations leading to the payment of claims, with the company retaining the final power of approval or disapproval. Expenses of the adjustment bureau are shared by all members on an equitable basis predicated in general upon the number and/or dollar volume of claims referred for adjustment.

Independent adjusters:

A great many companies refer their claims for investigation and adjustment to independent professional adjusting organizations who charge stipulated fees for their services.

Home and branch office adjusters:

A great many companies, particularly casualty companies, adjust claims through their own salaried employees stationed either at the home or branch offices as may be found more convenient.

Most companies use at least two and frequently all three of the foregoing methods of adjusting claims. They may have a claim branch office established for closer supervision and better control of the cost of adjustments in territories in which they have a concentration of risks. In the territories in which their business does not warrant the establishment of a claim branch office, they may use independent adjusters or join an adjustment bureau.

Reinsurance

Insurance companies bring together a great many persons subject to insurable hazards and collect from them amounts which, it is expected, will be sufficient in the aggregate to pay all losses which will be sustained by the persons in the group during a given period of time. To accomplish this purpose the number of persons brought together must be large enough for the law of averages to operate; otherwise it will be impossible to make a reasonable estimate of the amount of losses which will be incurred by the group. Frequently, however, an insurance company may be offered, or may be compelled to accept, insurance of a class of which it does not have enough volume in the aggregate to permit the law of averages to operate. Ordinarily all, or some part of, a risk of this type is passed on to another company. It also frequently happens that a company may write a policy on a risk for an amount which is beyond its financial capacity to absorb. It will, therefore, pass a part of the risk to another insurance company retaining only as much as it can absorb. It may also be, particularly in the case of fire insurance, that a company has too great a concentration of policies in one locality and, therefore, will pass on some of the risks in this particular locality to another company so as to reduce its con-

flagration hazard. Spreading of risks in situations such as these is called reinsurance.

The mechanics of reinsurance depend upon the reinsurance contracts or treaties which specify the relationship between the reinsurer and the reinsured. The following are the principal types of reinsurance:

Pro rata reinsurance. Pro rata reinsurance is a sharing, on a predetermined basis, by the insurer and the reinsurer of premiums and losses on a risk, class of risks or particular portion of the insurer's business. In consideration of a predetermined portion of the insurer's premium or premiums, the reinsurer agrees to pay a similar portion of all losses and loss expenses incurred on the business so reinsured.

1. Facultative reinsurance—Each risk or portion thereof is reinsured individually and the reinsurer has the option to accept or reject each.

2. Treaty reinsurance—To avoid the time and expense of negotiating desired reinsurance on an individual or facultative basis, companies enter into contracts (called treaties) providing for the automatic reinsurance of any agreed portion of business written, thereby eliminating the necessity for submitting each risk to the reinsurer for his acceptance or rejection.

   (a) Quota share reinsurance—This is a reinsurance of a fixed percentage of each and every risk of the insurer of the type covered by the treaty. For example, under a 50 per cent quota share treaty the reinsurer will receive 50 per cent of the insurer's premiums less a ceding commission and will be obligated to pay 50 per cent of each loss and loss expense incurred by the insured. Quota share reinsurance is frequently used for new lines or by new companies; for example, a fire company just entering the casualty field may arrange for quota share reinsurance of only its casualty business.

   (b) Surplus reinsurance—This type reinsures on a pro rata basis only those risks on which the coverage exceeds a

stated amount. Under a surplus treaty an insurer might reinsure what it considers to be surplus liability under each large dwelling policy which it writes. For example, the insurer might reinsure the amount of each dwelling policy over and above $25,000 so that on a dwelling policy for $40,000 the insurer would reinsure $15,000. He would therefore pay the reinsurer 15/40 or 37.5 per cent of the premium less the specified commission; in the event of loss under the policy the reinsurer would be liable for 15/40 or 37.5 per cent of the loss.

Excess reinsurance. Under this type of reinsurance, the insurer wishes to be protected against what it considers to be excess or shock losses. Since the insurer desires to limit its liability on any risk, class of risks or particular portion of its business to a stated amount, it contracts with a reinsurer to assume all loss in excess of this amount in consideration of an agreed premium. This type of reinsurance is generally used to supplement pro rata reinsurance and particularly on many casualty lines is used to supplant it. The costs of both the insurer and the reinsurer for processing excess reinsurance are much lower than for pro rata reinsurance.

1. Excess of loss reinsurance—This type of reinsurance provides that the insurer will retain for its own account all loss payments for each accident that do not exceed the stated amount or retention limit set in the agreement. The reinsurer reimburses the insured for the portion of any loss which is in excess of the insurer's retention. This type of reinsurance usually relates to each accident or occurrence, or series of accidents or occurrences arising out of one event.
2. Catastrophe covers—These are a special variation of excess of loss reinsurance, whereby the insurer protects himself from losses of more than a stated amount arising from any one loss or disaster of a catastrophic nature such as a hurricane or windstorm.
3. Stop loss reinsurance—Another type of excess reinsurance is the stop loss or excess of loss ratio reinsurance. This type of reinsurance provides that the insurer will suffer the losses

in their entirety until the total amount of loss is such that the loss ratio (losses divided by premiums) exceeds an agreed loss ratio; then the reinsurer will reimburse the insurer the sum that is necessary to bring the loss ratio down to the agreed percentage.

4. Spread loss reinsurance—Most commonly used in the fire insurance field it is designed to spread the insurer's losses over a period of years. The reinsurer agrees to indemnify the insurer for all losses over a stated amount as they occur. The premium for this reinsurance is customarily determined as a negotiated percentage of the sum of such losses over the most recent five-year period plus a charge by the reinsurer for this service. There is also both a minimum and a maximum premium for each year so that the insurer is protected to a certain extent against very large or shock losses.

Pooling

Pooling is the term frequently used to describe the practice of sharing all the business of a group of insurance companies affiliated or under common management among the members of the group. All premiums written by the associated companies are customarily ceded to or reinsured by one company; then, after provision for any required outside reinsurance, the premiums are in turn ceded back in agreed ratios. Losses, loss expenses, commissions, and other underwriting and operating expenses (excluding investment expenses) are similarly treated; each member of the group shares in the total business of the group and all will achieve similar underwriting results.

Underwriting Pools, Associations and Syndicates

There are in existence a large number of underwriting pools, associations and syndicates which were formed by several independent companies or groups of companies joining together in joint ventures to underwrite specialized types of insurance or to write in specialized areas through separate joint offices each with a distinctive name and a separate staff of employees. The asso-

ciations issue individual or syndicate policies on behalf of the member companies who share in all such policies in accordance with an agreement, or the policies are issued directly by the member companies and then reinsured among the members in accordance with the agreement. The agreement stipulates the organization and manner of operation of the association and the pooling of premiums, losses and expenses. Such associations customarily handle all functions in connection with the specialized business that would otherwise have to be handled by specialized departments in each of the member companies. This usually results in a more economical handling of such business.

Chapter 2

REGULATION

The insurance industry is deemed to be a business vested with the public interest and is regulated by the various states. Statutes in all states provide for the organization and maintenance of an insurance department charged with the responsibility of supervising insurance companies and enforcing compliance with the law.

While statutes vary, they have as their principal objective the development and enforcement of measures designed to promote the following:

1. Solvency
2. Propriety of premium rates
3. Fair dealings with the policyholders
4. Uniform financial reporting

In the interests of solvency, the statutes restrict investment of a part of funds of insurance companies to certain types of securities, prescribe methods of valuation of securities and other assets, require maintenance of minimum reserves, capital, and surplus, and define those assets which are not permitted to be reported as "admitted assets" in annual statements filed with insurance departments. (See section on non-admitted assets.)

Since 1944 when the United States Supreme Court held that insurance was commerce and, therefore, was subject to the laws of the United States and not to the exclusive jurisdiction of the various states, all of the states have passed legislation requiring the insurance commissioners to approve most rates charged by insurance companies. This decision made pricing of insurance in concert a violation of the anti-trust statutes of the United States. However, since action in concert is necessary for the welfare of

the insurance business and the public, Congress immediately passed the McCarran Act (Public Law 15) exempting the insurance business from the anti-trust laws of the United States so long as state legislation provides for supervision of insurance companies, including rate making. A company must file most rates with the insurance department of each state in which it is authorized to do business; no company may change its rates without formal or tacit approval of the state insurance department having jurisdiction.

The statutes also provide for certain standard provisions to be incorporated in policies and for the insurance department to review and approve the various forms of policies. Agents and salesmen must qualify for licenses granted by the insurance department before they may conduct business.

To promote uniform financial reporting, the statutes provide for the filing of annual or more frequent statements, in prescribed form, with the insurance departments and for the examination of insurance companies by the insurance departments at stated intervals. Annual statements are required to be filed on a calendar year basis.

In the majority of states, organization of insurance companies may not be undertaken without the authorization of the insurance department, and, in those states where such authorization is not required, approval of the insurance department is necessary for the completion of organization.

Insurance departments generally consist of an insurance director, commissioner or superintendent in charge with one or more deputies, and staffs of examiners, attorneys and clerical assistants. A commissioner usually is given a great many discretionary powers and can issue rules and regulations necessary to assure compliance with the statutes he is required to enforce.

National Association of Insurance Commissioners

The commissioners of the various states organized a National Association of Insurance Commissioners which meets twice a year and deliberates on the various subjects of interest to all insurance regulatory authorities. The Association has a number

of standing committees that meet throughout the year to work out various plans and proposals for submission at the semi-annual meetings of the commissioners. Although the findings of the Association are not in themselves binding on any state, once a final conclusion has been reached as to the need for new rules or procedures or for changes in the old ones, its recommendations are generally accepted and adopted by the states by appropriate legislation or regulation.

The important activities of the Association include the field of financial reporting and examination. Special committees of the Association have developed and are maintaining a uniform annual statement and an examiner's manual, which is in the nature of an audit program.

To minimize duplication of examinations, the National Association of Insurance Commissioners designed so-called "convention examination" procedures. For this purpose, the country is divided into six zones with one state commissioner in each zone designated as chairman of the zone. Whenever a domiciliary state decides that an insurance company within its jurisdiction is subject to examination, it so advises the chairmen of all of the zones in whose territory the company transacts business. Each chairman then designates one of the states within his zone to represent the zone in the examination. The examining staff, therefore, consists of the domiciliary state examiner who takes charge of the examination and representatives of all or some of the zones in which the company transacts business. The report of this examination is filed with the chairman of each zone concerned and is known as a report on the "convention examination." The convention examination generally satisfies the statutory examination requirements of each state in which the company transacts business thereby eliminating the duplication which would occur if each conducted its own examinations of all companies coming within its jurisdiction.

Chapter 3

UNDERWRITING OPERATIONS — PREMIUMS

Daily Report ("Dailies")

One of the most important records in an insurance office is the daily report, sometimes called an "application," which is the company's copy of the policy that has been issued. It is the basis of practically all accounting and statistical information and should therefore include a complete record of all transactions affecting the policy.

The daily report is a duplicate copy of a portion of the policy written, containing all the information necessary for accounting and statistical purposes. The policies contain many printed conditions which are unnecessary in the daily report as they are standard and are familiar to the company's employees. Some companies use an abstract form for the recording of casualty transactions.

As the term "dailies" implies, copies of policies issued by agents are received in each day's mail at the company office. Copies of policies written in the offices of the company are, of course, immediately available for processing. If policy control is maintained, the dailies will be sent to departments maintaining such control so that the issuance of each policy may be noted on control records. Control records may consist of a list on a sheet or card of the policy numbers requisitioned from stock with sufficient space opposite each number to indicate by a date stamp, check mark or other symbol that the daily report has been received. An alternative method of handling policy control is to use a tabulated listing of policies written and recorded during the month (or a shorter period) as the basis for noting on the policy control record that the policy has been accounted for. In addition

to being more efficient, this method proves that the policy has been issued and recorded.

Follow up of missing dailies, as indicated by missed policy numbers, is usually made periodically using form letters sent to the agents or branch offices listing the items that are missing and requesting, as to each item, the reason for the nonreceipt, or the dates of mailing if forwarded prior to receipt of the form letter.

A change in an existing policy is reported on a standard form referred to as an "endorsement" which is processed in much the same manner as the daily. The change may result in an additional premium, a return premium or no premium adjustment.

The "dailies" are distributed to underwriting departments where they are reviewed for acceptability of the risk and determination of the premium. If the business was produced by an agent or broker, the rate of commission (in code where data processing equipment is used) is entered opposite each item, unless commission rates are standardized so that the commission may be calculated on the total writings for the month. Many companies, in order to speed up the recording of business, preliminarily review the dailies, insert the commission rate, code and record them, and then perform the underwriting function.

In most states, a checking office or inspection bureau is maintained by the companies, either voluntarily or in accordance with state laws or regulations, to prevent rating violations on fire and extended coverage risks. Agents, if required, send their daily reports to the checking office and the latter, after inspection, forwards them to the company. Most inspection bureaus check only the rate on the daily so that before the daily reports start on their way through the accounting department, the computation of the total premium as entered by the agent will be checked or test-checked.

Reinsurance

Among the matters to be determined by the underwriting department are reinsurance arrangements. Underwriters usually note information relative to reinsurance on the daily reports or on special reinsurance forms attached to the "dailies." They note

the amount of reinsurance to be effected with each of the facultative companies and under each treaty contract, and the date on which each of the reinsurance amounts is to be bound, which is ordinarily as of the date the policy was written.

Preparation of Records from Dailies

Dailies are usually sorted into batches in the underwriting departments. Each batch is coded and routed to the key punch division where cards or paper tapes are punched directly from the daily reports. In those companies where daily reports are abstracted, punching is done from the statistical copy of the abstract. The number of cards punched from the daily report depends on the system used and whether premium accounting is done on punched cards, magnetic tape, bookkeeping machine or other methods. Where all work is done on punched cards generally two sets of cards are prepared, accounting and statistical. When electronic data processing equipment is used, only the number of cards or the amount of paper tape necessary to record the required data is used. When bookkeeping machines or other methods for recording premiums receivable are used, daily reports or abstracts are routed to the bookkeeping machines for accounts receivable recording and then to the key punch division for punching of statistical cards. The monthly tabulations prepared from the statistical cards, classified by agents, or the totals accumulated by the EDP equipment, serve as a basis for entries recording the direct business written for the month, and establish controls for agents' balances.

Premium Balance Accounting

Some companies send monthly statements to their agents, while others supply their agents with "account current" forms which are prepared by the agents monthly. The forms generally provide a column for policy numbers and several columns for premiums so that all premiums subject to the same rate of commission may be segregated in the same column to facilitate the calculation of commissions. Provision is also made for recording return

premiums, expenses or other items affecting computation of the agent's balance.

When "accounts current" are received from agents, a comparison is made of the listed transactions with those recorded on the company's records. This comparison usually discloses differences which require investigation by the company.

Most companies record on their books as premium income and uncollected premiums the totals accumulated from the dailies. There are many ways of handling differences between premiums as so recorded and as reported in the agent's account current. One method commonly in use (for companies on a punched-card basis) is to remove from the uncollected premium file cards representing items included in the agent's account current and to insert in their place one card for the net balance reported in the agent's account current and suspense cards, debit or credit, for (1) items included in the agent's account current but not yet recovered by the company and (2) differences between items included in the agent's account current and as recorded by the company. Variations of this method are used for premium balance accounting when mechanical or electronic equipment is used. Most companies utilize some method for establishing accounting control over these differences; many companies use a separate account entitled "agents' differences." However, some companies record premiums as reported in the agent's accounts current and carry differences in memorandum records.

Some companies carry their uncollected premium records on a gross basis while others carry these records on a net basis (net of commission).

There are at least two other basic methods in use by agents and brokers for premium balance accounting:

1. The company renders the agent or broker a monthly statement either on an individual item or on an account current basis.

2. The agent or broker pays the company for individual premiums as he collects from the insured.

There are also many companies that render a statement di-

rectly to the insured who, depending on circumstances, pays his premium directly to the company or to his agent or broker.

Insurance companies attempt to develop premium accounting systems so that any of the above methods may be used by agents, brokers or insureds in reporting and paying premiums.

The procedure followed for agents and brokers who do not report on the account current basis is, in general, similar to that outlined for account current agents, except that each premium transaction is treated as an individual item rather than treating the entire month's business of the agent as a unit for collection purposes. Accordingly the premium accounting department receives individual charges or credits for each policy, equal to the total monthly entry to the uncollected premium account. The individual records are usually received in the form of punched cards or abstract tickets. When premium balance accounting is performed by mechanical or electronic equipment each policy item may also be treated individually.

Reinsurance Accounting Records

In the case of facultative reinsurance, a monthly listing (or bordereau) detailing the particulars pertaining to each risk reinsured during the month is the usual method employed by the ceding company in reporting to the reinsurer. Treaty reinsurance is frequently handled in totals only, on a monthly or quarterly basis.

The accounting entries involving reinsurance ceded are relatively simple if one bears in mind that the ceding company is in the position of a purchaser of insurance coverage from the reinsurer: a charge is made to "Premiums on reinsurance ceded" offset by credits to "Commissions on reinsurance ceded" and "Ceded reinsurance balances payable." Conversely, since the reinsurer takes the position of the seller, he records the transaction by charging "Uncollected premiums" and "Commissions on reinsurance assumed" and crediting "Premiums on reinsurance assumed."

When pooling arrangements are in effect no reinsurance records are prepared until the direct writing records have been

summarized and monthly or quarterly totals are complete. In other words, under a pooling arrangement, the only reinsurance entries required are prepared from totals of business written.

Audit or Reporting Premiums

The risk on many policies is not known at the time the policy is written; consequently, a deposit premium is charged at the inception of the policy. At intervals during the term of the policy or at the expiration of the policy the insured submits reports, or a company representative audits the insured's records, to enable the company to determine the premium for the period. The premium for workmen's compensation insurance, for example, is predicated upon the insured's payroll. The insured receives credit for the deposit premium when the final determination of the premium is made.

Installment Premiums

Many policies are written so that the premium is payable in installments. Annual premiums are frequently payable in three or more installments; premiums on longer term policies are frequently payable in annual installments. There is usually a small surcharge made for the privilege of paying on the installment basis. Some companies record the total premium on three- or five-year installment policies, together with related commissions, at the time the policies are issued. Others only record each annual installment as it becomes due.

Unearned Premiums

As soon as a policy is issued promising to indemnify for loss, the insurance company incurs a potential liability. The company may be called upon to pay the full amount of the policy, a portion of the policy, or nothing. It would be impossible to try to measure the liability under a single policy. However, since insurance is based on the law of averages, one may estimate from experience the loss on a large number of policies.

As state supervision of insurance developed, the insurance departments set about providing a legal basis for determining the potential liability under outstanding policies in order to establish an ample reserve for the protection of policyholders and provide a uniform method of calculation. It was recognized that, since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term on a uniform basis for all companies. Therefore the unearned premium was adopted as the basis for computing the unknown liability on unexpired policies.

Statutory requirements, including methods of establishing the unearned premiums may be illustrated by the insurance law of one of the states, which reads in part as follows:

> Every insurer authorized to transact business in this state shall . . . maintain reserves equal to the unearned portions of the gross premiums charged on unexpired or unterminated risks and policies . . . The liability for unearned premiums may be computed on the annual pro rata fraction basis applicable to the date of settlement as prescribed by the superintendent . . .
>
> In case the annual pro rata fractions do not produce an adequate reserve the superintendent may, in his discretion, require an insurer to calculate its unearned premium reserve upon the monthly pro rata fractional basis or if necessary, on each respective risk from the date of the issuance of the policy and in the case of premiums covering indefinite terms he may prescribe special regulations.

The annual pro rata basis assumes that business is written uniformly over the calendar year; consequently, it is assumed that all policies are issued at the middle of the year which is then the average date of issue. For example, on a three-year policy the unearned fraction at the end of the calendar year in which written would be 5/6, at the end of the next year 3/6, and at the end of the following year 1/6.

The annual pro rata basis produces reasonably accurate reserves only when a substantial portion of the business is distributed

evenly over the year. If, because of seasonal or other circumstances, there is a preponderance of business in the first or last half of the year the reserve may be excessive or inadequate.

The monthly pro rata basis assumes that, on the average, the same amount of business is written each day of any month so that the mean will be the middle of the month. For example, one-year premiums written during the first three months of the year have at the end of the year the following unearned fractions: January–1/24, February–3/24, March–5/24.

Fire and casualty companies, with few exceptions, use the monthly pro rata fractional basis. Unearned premiums are calculated by applying the appropriate fractions or factors to the original premiums in force segregated by line of business, term and expiration. The premium for the full original term is used for this purpose since the fractions or factors are calculated on this basis. When a policy is cancelled it is necessary that the full original premium be deducted from the total premiums in force; otherwise premiums in force and unearned premiums would be overstated. During the life of a policy, changes are frequently made resulting in additional or return premiums. For example, a one-year policy expiring in June, 19xx may have the rate increased or decreased by a change in hazard after it has been in force for six months, in which case the insured might pay an additional premium or receive a return premium. Theoretically the full original premium for changes should be noted on the copy of the endorsement attached to the "daily" so that premiums in force for the one-year term expiring June, 19xx may be correspondingly increased or decreased; however, as a practical matter, many companies adjust the premiums in force by the amount of the actual additional premium or return premium, other than in the event of cancellation, on the assumption that the resulting errors in the premiums in force will largely offset.

If a company accepts reinsurance on a risk in mid-term, it must provide the same unearned premium reserve that would have been provided by the ceding company if reinsurance had not been effected. Therefore, because of the method of calculation of the unearned premium reserve, the original premium for the full term of the policy should be included in the premiums in

force; otherwise the unearned premium reserve on the risk will be understated.

The basic data for calculation of unearned premiums (namely the term, expiration and original premium) is included in the basic punch card or other media used to record premium transactions. Periodically summaries are made by line of business, term, month and year of expiration if the company uses the monthly pro rata basis or by year of expiration if the company uses the annual pro rata basis. The total of these summaries is usually referred to as the contribution to the "in force" for the period. These summaries are combined with summaries of the premiums in force at the beginning of the period and, after expired business is excluded, result in premiums in force at the current date. Companies using electronic computers accumulate the necessary "in force" data on punched cards, magnetic tape or in the memory of the computer. The unearned premiums may then be calculated mechanically or electronically.

For purposes of the annual statement insurance companies are required to maintain their records so that they can determine separately at December 31:

1. Premiums in force on direct and reinsurance assumed business.
2. Premiums in force on reinsurance ceded business.

In order to save time in the calculation of the unearned premium reserve, most companies deduct reinsurance in force from gross premiums in force to arrive at net premiums in force.

Unearned Premiums on Unauthorized Reinsurance

Where reinsurers are not authorized to transact business in a particular state they are not subject to examination by that state; consequently, the state will not allow the insurer to reduce its liabilities because of reinsurance ceded to unauthorized reinsurers. Since unearned premiums in the annual statements are reduced for all reinsurance ceded, the insurer is obliged to establish a separate liability for unearned premiums on reinsurance in force with unauthorized reinsurers. The insurer is permitted to reduce

this separate liability to the extent that he is holding funds of such reinsurers.

As unauthorized reinsurers vary from state to state, some companies calculate the separate liability with respect to their reinsurers unauthorized in any state in which the company transacts business and use this liability in the annual statement filed with every state in which it is licensed.

Outline of Auditing Procedures

The audit of premiums written, premiums in force and unearned premiums is interrelated with the audit of many other items in the financial statements of insurance companies. Inasmuch as the dailies are the basic records from which transactions are recorded, maximum efficiency may be obtained by co-ordinating the auditing procedures relative to premium income, commissions and expense allowances to agents and brokers, reinsurance assumed and ceded and related commissions, agents' balances or uncollected premiums, bills receivable taken for premiums, funds held by or deposited with ceding reinsurers, unearned premiums, certain casualty loss reserves and various expense liabilities.

An outline of a program relating to the audit of premium income and related accounts is presented in the following paragraphs:

Accounting for Policies Issued. A substantial number of companies do not maintain policy control; where policy control is maintained, a limited test should be made to determine that policies supplied to agents are promptly entered on the policy control records. A test should be made to determine that skipped policy numbers are investigated in accordance with the prescribed procedures of the company. A limited test might also be made to determine that policies shown by the policy control records to have been issued and received from agents have actually been so received.

Whether or not policy control records are maintained, a test should be made to determine that daily reports are recorded

prior to filing. This can usually be accomplished by a test examination of daily reports in the files to determine that they bear entry stamps indicating that all premium transactions reflected thereon have been recorded.

Premium Income. The examination relative to premium income may be made by: (1) reviewing daily reports of selected agents and brokers for selected periods; (2) sampling transactions for the entire year under review; or (3) inspecting all recorded transactions for a selected period. All premium transactions reflected on the daily reports including reinsurance ceded transactions should be traced to the premium or transaction registers to determine that they have been properly recorded, particularly noting that term, month and year of expiration, and actual and original premiums have been properly entered. Such a test assures that the basis for premiums entering the premium in force and unearned premium records is proper. Where premium or transaction registers are not produced, because of the use of electronic equipment or for other reasons, the auditor should investigate the system of internal control in use and design his program accordingly.

For agents' accounts included in the test who render an account current to the company, the auditor should determine that daily reports used in the test have been properly reported by such agents as to both premiums and commissions thereon and that differences are under investigation on a timely basis. Accounts current utilized in these tests should be traced to proper entry in the agents' balance control and subsidiary records.

For all agents' and brokers' accounts selected in the test, regardless of whether they render an account current, determination should be made that commission rates shown by the daily reports are in accordance with contractual arrangements.

For agents and brokers who report on other than the account current basis or where premium balances are controlled gross, the auditor should examine a selected number of remittances to determine that differences, particularly commission differences and unsupported return premium deductions, are being investigated and resolved within a reasonable time.

Where reinsurance ceded is indicated by dailies, the computation of reinsurance premiums and commissions should be tested. In the event of return premiums or cancellation of the policy, the auditor should particularly note that the reinsurance return premium has been recorded.

The independent auditor should review the reinsurance contracts or treaties and test payments of commission on reinsurance assumed and ceded to determine that the commissions are in accordance with such contracts or treaties. Commissions on agency reinsurance assumed and ceded and on some other facultative reinsurance may usually be conveniently audited in conjunction with the audit of commissions on direct premiums. Commissions on reinsurance assumed or ceded, which is reported on monthly or quarterly accounts, may be readily audited by reference to such accounts and to the reinsurance treaties and, where more than one commission rate is involved, by reference to supporting details of premiums.

A review should be made of the procedures and controls in effect for the collection of earned premiums on auditor reporting form policies. Earned premiums receivable are frequently only controlled on a memorandum basis.

For three- and five-year installment premium dailies, the auditor should ascertain statistical department or other records are being properly maintained to insure entry of future installments.

Determination should be made that return premium transactions included in the test are properly supported by endorsements or cancellation evidence. A test-check of the calculation of return premiums is necessary; in the event of cancellation the original premium should be properly noted on the related daily report.

Records used in tests should form the basis for entry in the books of account; tests of footings, postings and calculations should be made where appropriate.

Many companies cut off premium registration somewhat earlier at year end than during interim periods. In addition, delays due to mail and checking of dailies by rating and inspection bureaus frequently result in a significant amount of December or prior months' business not being entered until the subsequent year.

However, there is frequently a substantial backlog of endorsement transactions (additionals, returns, cancellations and earned audit or reporting form premiums) due to inability to locate dailies, delay in making audits, delay in receipt of value reports from insureds, etc. There is also frequently a greater delay in the recording of reinsurance ceded transactions than there is in the recording of direct transactions (reinsurance ceded commissions are, of course, usually substantially in excess of commissions allowed to agents and brokers).

Since these factors tend to offset, the financial statements may not be materially affected; the company's practices as to these transactions at the year end should be ascertained and tests made to determine the effect on the financial statements.

Agents' Balances or Uncollected Premiums. Lists of agents' balances and uncollected premium account balances should be reconciled with the general ledger control account balance. Aging of the balances should be reviewed to ascertain that client's segregation as between "admitted" and "non-admitted" assets is in accordance with the requirements of the state insurance department.

Selected premium or agents' balances and balances resulting from reinsurance assumed should be confirmed. While it probably will be found practicable in most instances to confirm amounts receivable from agents by listing the open account current monthly balances, confirmation from brokers and others usually must be obtained on an individual policy basis. The propriety of the items for which confirmation was requested but not received should be tested by tracing details thereof to dailies and subsequent collection.

Entry of premium transactions in the premium register and in the agents' balance or uncollected premium records and the handling of differences should be tested in conjunction with premium income tests previously discussed.

Unearned Premiums. The company's unearned premium reserve will frequently be supported by listings of premiums in force and unearned by line of business and by term and ex-

piration date. However, many companies using electronic data processing equipment do not make a list of in force and unearned in sufficient detail so that calculations can be checked. In this case arrangements should be made (preferably in advance) to secure detailed listings by terms and expiration for at least selected lines of business. Review the principles followed in the determination of premiums in force and test the calculations of the portion unearned. (The procedures for testing the recording of premiums for premium in force purposes were discussed in conjunction with the test of premium income.)

An analysis, with appropriate tests, of changes of premiums in force should be made for a selected period by lines of business as follows:

Premiums in force at the beginning of the period
Plus: Premiums written
Excess of original premiums over amounts received for additional premiums (endorsements) and reinsurance
Less: Excess of original return premiums over actual return premiums
Expired premiums
Premiums in force at the end of the period.

Relationships among these items should be scrutinized and compared with those of prior periods.

A listing of premiums expired during the period should be secured and tested to determine whether they are actually expired. Comparisons should be made separately of actual and original premiums as to both premiums and return premiums by line of business. Quantity and ratio comparisons should also be made of premiums in force, unearned premiums and premiums written by line of business for the current year and at least the prior year; unusual fluctuations noted in these comparisons should be investigated. Unusual reinsurance transactions or changes in trend from long- to short-term business may be the cause of some fluctuation.

Determination should be made that business from all sources (such as pools, associations, reinsurance assumed, etc.) has been included in premiums in force and unearned.

Unearned premiums should also include separate allowances

for rate credits and retrospective return premiums based on experience as follows:

1. Return premiums due to retrospective ratings on compensation and liability policies. The premiums on such policies are determined after expiration based on the loss experience.
2. Audit return premiums on various casualty, fire or marine policies.
3. Return premiums due the insured under the policy for certain periods when the vessel is laid up.
4. Additional reserves on noncancellable accident and health policies.
5. Reserves for deferred maternity and other similar benefits.

A review should be made of the methods used in determining the allowance for retrospective return premiums and rate credits included in the unearned premium reserve. It should be determined that the methods used are appropriate and consistent with methods used in prior years; calculations and underlying data should be tested.

If the company only enters the current installment of premiums payable in annual installments, determination should be made that any necessary adjustment has been made in premiums in force and unearned; unearned premiums may be understated because, at times, the first installment on a policy may be somewhat higher than the other installments.

A listing of reinsurance in force by reinsurer should be reviewed; if there is any reinsurance in force with unauthorized reinsurers a liability should be established for the related unearned premiums. The liability is only to be established for the amount by which the unearned premiums on such unauthorized reinsurance exceed the funds of such reinsurers which are being held by the company. Funds held for the account of reinsurers, whether authorized or unauthorized, should be confirmed on a test basis.

Chapter 4

UNDERWRITING OPERATIONS — LOSSES AND LOSS ADJUSTMENT EXPENSES

Losses and related adjustment expenses incurred by an insurance company under its policies represent, in most lines of insurance, the largest single element of the cost of doing business. The fairness of the company's representation of its financial position and results of operations usually rests on the reasonableness of the estimates of unpaid losses more than on any other item. However, it is extremely difficult to estimate this element of cost accurately.

In most businesses cost information is available before sales are made. In the insurance business, however, the cost of the protection sold cannot be finally determined until after policies have expired and any losses adjusted. No peculiar or difficult accounting problem is encountered with losses that have been settled or with most property losses where reasonably definite information has been obtained; the determinations made in these cases usually result merely in minor corrections of estimates previously made. But the need to make provision, frequently far in advance of settlement for many casualty losses (i.e., liability, compensation, fidelity and surety losses) and for losses which have been incurred but have not been reported, presents a difficult problem, the resolution of which calls for the exercise of the greatest care and soundest judgment.

Since past experience is the principal basis used in the determination of the latter types of losses and related expenses, insurance companies pay great attention to the compilation of various loss data and to the development of related experience

statistics. The importance of the completeness and quality of such material and the manner in which and the degree to which it is currently utilized in the company's loss accounting cannot be overemphasized.

Processing of Losses

The term "processing of losses," embraces all procedures and performances of the company incident to investigation, adjustment, payment or other disposition of losses and claims, and also includes related accounting and the development and maintenance of loss experience statistics.

Multiple line insurers usually have separate departments or sections to handle different types of losses and claims because of inherent basic differences. Property losses can usually be determined and settled in relatively short periods of time. However, many casualty claims present a wide area for disagreement and often require prolonged investigation and negotiation before agreement is reached as to the amount of damages.

In large companies there may be further specialization in the settlement of losses. Separate departments or sections may handle marine losses, workmen's compensation claims, claims under fidelity and surety bonds, and claims under miscellaneous lines of business.

Although detailed procedures vary, there is a common pattern of processing losses. Notices of loss or accident are received at the home or branch or divisional offices, either directly from the insureds or through agents or brokers. File numbers, which form a basis for all future references, are assigned to the cases reported. Cases may be registered in numerical sequence or other means of control may be provided. Dailies or applications are examined to determine that reported losses are actually covered by insurance policies in force at the time of the occurrence. If proper coverage exists, cases are assigned to adjusters for further field investigation, appraisal, negotiation and settlement, subject to appropriate supervision and approval by the company's loss department. The adjusters in the course of their investigations will determine, among other things, whether the claimed

losses actually occurred, what they deem to be the proper amount of the losses, whether the losses may be excludable under the terms of the policies, and whether the company has any rights of salvage or subrogation.

Salvage is a recovery frequently made by the insurer after a loss has been paid and is treated by the company as a reduction of the amount of loss paid. Salvage recoveries are exercised by the insurer as a contract right which entitles it to any reimbursement arising from the disposal of property which has been damaged and for which the claim of the insured has been paid. Subrogation is the statutory or legal right of an insurance company to recover from a third party who may be wholly or partly responsible for the loss paid under the terms of the policy. Subrogation recoveries, similar to salvage, are applied in the accounts as reductions of losses paid.

As soon as practicable, estimates are made of the probable amounts payable on reported losses. Such estimates may be made on the basis of experience developed, by line of business, as to the average cost per case, or may be made on the basis of reported information with respect to individual cases. Revisions of these estimates are made, where appropriate, as changes in experience indicate or as investigations progress. Many insurance companies do not enter loss estimates in the general ledger but only maintain detailed memorandum records of them.

Various clerical operations are performed after notices of losses are received. Separate loss or claim files are prepared for the filing of all papers relating to each case. In addition, transcripts of loss containing abstracts of coverage and of loss notices, generally known as face sheets, as well as a considerable amount of coded information for later use in the development of statistics, are prepared in some multiple form. Copies of this form may be used for inclusion in the loss file for ready reference, as a branch office record, as an adjuster's assignment sheet, as a diary for home office follow up on the progress of settlement, as a claim card for the loss department's record of outstanding losses, as a notice to the tabulating department to prepare punched card or other records of case reserves and appropriate statistical distributions, as a notice to the underwriting department of current develop-

ments and to some extent as an experience record, as an index of insureds and claimants, and as a claim register.

As is readily apparent, the procedures described above are costly; consequently, there has been much effort to process smaller and "one shot" claims by less expensive methods. Usually this is accomplished by eliminating the preparation of an expensive set of claim records and the recording of an individual estimate on each small claim. There have been many methods developed to accomplish this including:

1. The combination and processing of a large number of small claims as one claim for statistical and accounting purposes.
2. The delay of all statistical and accounting processing until date of payment.
3. The use of average reserves on small claims.

Loss Accounting and Payment Procedures

Loss and loss expense payments may originate with a number of documents, including: signed proofs of loss, releases, medical bills, repair bills, or invoices for fees of independent adjusters, lawyers, etc. When these documents are received, they are reviewed and compared with the loss files; if in order payment is authorized. Authorized payments may be posted to the face sheets of the loss files and to the loss department's claim cards at this time. For reasons of economy some companies do not post loss payments either to the face sheets or claim cards but include evidence of such payments in the loss files.

Methods of payment vary among insurance companies. Approved documents may be forwarded to the cashier for draft or check preparation or the loss department may have authority to issue drafts. In many cases drafts may be issued by field offices, adjusters and sometimes agents. In such cases, copies of the drafts together with the supporting documents are forwarded to the loss department. After processing, the supporting documents are filed in the related loss files.

Accounting for losses paid by checks or for drafts handled on an issued basis commences at the time of issue. Some insurance

companies record drafts issued in payment of losses only when the drafts are presented for payment by banks; accounting commences at that time. Drafts presented for payment should be compared with approved copies of the drafts.

Loss payments are classified by the use of source records (copies of checks or drafts, check requisitions, or other material). The records may be summarized manually but usually data processing equipment is used. In the latter case source material is forwarded to the data processing department, usually in controlled batches. Loss transactions are punched from the source material and totals of paid losses become the basis for posting to the general ledger.

Losses and claims must be classified by lines of business, as well as by state, location of risk and in some instances by date of loss and policy year in order to meet the reporting requirements of the annual statement.

Unpaid Losses and Loss Adjustment Expenses

The provision for unpaid losses and loss adjustment expenses includes estimates of losses in process of settlement, estimates of losses that have been incurred but which have not been reported, and estimates of loss adjustment expenses to be incurred in settling outstanding losses. To serve as a guide in the exercise of judgment with respect to current estimates, insurance companies, particularly in the case of casualty losses, rely heavily on past experience modified in the light of current conditions and trends. "Development" or "runoff" data is one of the most useful guides for this purpose. The preparation of such data involves a comparison by (1) policy and accident year, or (2) calendar year, of the estimates carried for reported and unreported losses outstanding at the end of a period with the subsequent "cost" of such losses to date, represented by actual payments plus the estimates for losses still unpaid. The development of experience data over a period of years provides an extremely useful pattern by which management may gauge the judgment of those charged with the responsibility of estimating loss reserves. Substantial differences disclosed by comparisons of estimated and actual costs

of losses are usually investigated and may well indicate the need for adjustment of current estimates.

"Developments" are frequently prepared by line of insurance as shown on page 34.

Reported Losses. Estimates of reported losses in process of settlement are determined by inventory, i.e., by tabulation of loss estimates. Case reserves on larger losses are estimated on an individual basis by claim examiners from information supplied in loss notices and adjusters' or investigators' reports. The same procedure may be followed for small losses; however, the large volume of small losses causes many companies to arrive at these estimates by multiplying the number of outstanding cases by an average dollar amount per case determined on the basis of past experience.

Unreported Losses. Estimates of losses incurred but not reported are generally determined on a formula basis, i.e., the estimates are established on the basis of experience statistics of prior periods, modified, where indicated by current trend and other factors. One method used is to relate, by line of business, the emerging losses for a selected period or periods to the premiums in force at the beginning of such period or periods, and then to apply the factor thus derived to the premiums in force at the end of the current year. Another method is to relate the number and amount of claims reported after the close of a prior year or years to the total claims reported for those same years. The factor so developed is applied to the total claims reported for the year under review.

The formula basis of computing estimates is ordinarily used only for the normal run of losses. Exceptionally large losses, such as those to be paid in the event of a catastrophe, are excluded from the experience statistics and separate estimates are provided on the basis of available information and best judgment.

Loss Adjustment Expenses. Provisions must be made not only for reported and unreported losses, but also for the future costs of settling such losses. Loss adjustment expenses may be

Development at December 31, 1965 of Reported Losses at December 31, 1963 on a Calendar-Year Basis

Provision for Losses Reported Dec. 31, 1963 or Prior and Unpaid at Dec. 31, 1963	Loss Payments Jan. 1, 1964 - Dec. 31, 1965 Applicable to Losses Reported Dec. 31, 1963 or Prior	Losses Reported Through Dec. 31, 1963 Still Unpaid at Dec. 31, 1965	Developed Cost at Dec. 31, 1965 of Losses Reported Through Dec. 31, 1963 and Unpaid at Dec. 31, 1963	Indicated Savings or (Deficiency)
$2,000,000	$1,200,000	$700,000	$1,900,000	$100,000

Development at December 31, 1965 of Incurred But Not Reported (IBNR) Losses at December 31, 1963 on a Calendar-Year Basis

Provision for IBNR Losses at Dec. 31, 1963	Loss Payments Jan. 1, 1964 - Dec. 31, 1965 Applicable to Losses Incurred Dec. 31, 1963 or Prior and Reported Subsequent to Dec. 31, 1963	Losses Incurred Through Dec. 31, 1963 But Reported Subsequent to Dec. 31, 1963 and Unpaid at Dec. 31, 1965	Developed Cost at Dec. 31, 1965 of Losses Incurred But Not Reported at Dec. 31, 1963	Indicated Savings or (Deficiency)
$400,000	$280,000	$160,000	$440,000	($40,000)

classified as allocated or unallocated. Allocated expenses are usually considered to be those which can be directly identified with specific cases; unallocated expenses are usually considered to be those which cannot in any practical way be so identified (i.e., salaries, travel, rent, postage, stationery, etc.).

Provisions for loss adjustment expenses are usually estimated on a formula basis; however, some companies use case basis estimates. The formula factors may be developed by relating allocated paid loss expenses by line of business to paid losses, frequently for the most recent three- to five-year period; these factors, adjusted for trends, are applied by line of business to the unpaid losses at the time that financial statements are prepared. Because some portion of the expenses will have already been paid on many of the open cases, it is not unusual for companies to discount the ratio of expenses to paid losses on the basis of experience. Another and perhaps sounder method of estimating unpaid allocated loss expenses is to prepare a development schedule similar to that previously discussed for losses; the ratios developed from such schedules are applied to the current unpaid losses and adjusted for trends. Further refinements are often made. For example, experience data may be developed as to loss expense paid in the first year after the reserve date, the second year, the third year, etc.

Required provisions for unpaid unallocated loss adjustment expenses are generally estimated by relating paid loss expenses to paid losses for a prior period or periods and applying the developed ratios to unpaid losses at the statement date. Such ratios are usually applied in full to incurred but not reported loss provisions and, because a fairly substantial amount of such loss expenses has already been paid on reported losses, the ratios are usually reduced on the basis of judgment (very frequently by 50%) and then applied to unpaid reported losses.

Statutory Formula Reserves. Minimum reserves are required by statute in many states for bodily injury liability and workmen's compensation lines of business. They are computed by applying a stipulated percentage to the amount of earned premiums on policies written in each of the three most recent calendar years

(60% for bodily injury liability and 65% for workmen's compensation) and deducting from the result the loss and loss expenses actually paid on these policies. The minimum reserves so determined are compared with case basis loss and loss expense estimates ("case basis" as used in this sense includes reported and incurred but not reported cases and expenses applicable thereto); the larger amount for each of the three years is carried as the required reserve for the respective years. The case basis estimates for unpaid losses and loss expenses on policies which are more than three years old are added to these reserves, as well as any related voluntary additional reserves that a company may provide. Any excess of liability and compensation statutory and voluntary reserves over case basis and loss expense estimates is shown separately in the annual statement as a liability and any change in the excess between accounting periods is reflected in surplus.

Minimum reserves are also required in some states for losses incurred but unreported on fidelity and surety policies as at the statement date. These reserves are provided on the basis of prescribed percentages of the premiums in force for the respective lines of business.

Reinsurance Recoverable

The loss department, upon receiving a notice of loss, generally determines whether there is any right of recovery under a reinsurance agreement. In the case of pro rata reinsurance (other than quota share) this determination will be made by inspecting the daily report which shows appropriate reinsurance information. Recoveries under quota share reinsurance agreements are usually based on the appropriate total loss figures for the period. In the case of excess reinsurance the determination is made by the loss examiner based upon the terms of the applicable reinsurance contract. Recoveries under catastrophe reinsurance are usually determined on the basis of data compiled by the statistical department; each catastrophe is usually assigned a code number and a recovery is set up when the total incurred losses for any one catastrophe exceed the company retention.

When it has been determined that there will be reinsurance recoverable on a loss, the estimated amount recoverable is usually recorded on the claim file and on the data processing records either on a separate reinsurance recoverable loss reserve punched card or on magnetic tape, etc. Notices of losses are sent to reinsurers in accordance with terms of reinsurance contracts, in most cases, only for losses reinsured on a facultative basis and for the larger losses. The annual statement provides for reporting gross unpaid losses, related reinsurance recoverable and net unpaid losses. Listings prepared from the data processing records at statement dates provide the required data. The estimated amounts of unpaid losses recoverable from reinsurers are not recorded, except in very rare cases, on the general records. When losses and loss expenses are paid, however, most companies record the actual amount of reinsurance recoverable both in the general ledger and in subsidiary records which are frequently in the form of punched cards or magnetic tape. Some companies maintain a record of reinsurance recoverable on paid losses on a memorandum basis until collection is made.

Reinsurance recoverable balances must be segregated as between those recoverable from authorized companies and those recoverable from unauthorized companies. Insurance companies are required to provide a reserve for reinsurance recoverable from unauthorized companies to the extent that funds held or retained for account of unauthorized companies are exceeded.

Outline of Auditing Procedures

Generally, a review and tests of the loss procedures of an insurance company may be commenced at an interim date. The review should include an appraisal of the effectiveness of the loss department's supervision of loss settlements, reserving practices, and an evaluation of the soundness of the related internal procedures and controls in effect.

Paid Losses and Loss Adjustment Expenses. Detailed lists of paid losses, allocated loss adjustment expenses and reinsurance

recoverable for a selected period or periods should be obtained and traced to the general ledger accounts. Loss or claim files should be examined for selected paid losses and allocated loss adjustment expenses. This examination should include inspection of dailies or applications to determine that the paid losses were covered by the insurance contract, were within the policy limits, and occurred within the policy period. Tests should also be made of account and other coding classifications. In addition, inspection should be made of proofs of loss, releases, loss expense invoices, correspondence from field adjusters and examiners' approvals. In the course of these tests the auditor should refer to related paid drafts or checks for propriety of amounts, and names of payees and endorsers.

Companies who use adjustment bureaus usually pay for adjustments of losses and claims on a monthly basis predicated upon the number of losses adjusted and a gradation of such losses by size; payments should be test-checked. It should be determined that the company, at least periodically, requests from the adjustment bureaus lists of paid losses on which it is being charged adjustment expenses and that the company at least tests such payments against its records.

In the course of examining loss or claim files to which reinsurance applies, losses and allocated loss adjustment expense recoverable should be traced to the reinsurance records. Rights to salvage or subrogation should be noted. A review should be made of the procedures and controls in effect for such items, and subsequent collections should be traced, on a test basis, through the accounting records.

Consideration may also be given to the desirability of confirming, on a test basis, payments to insureds or third parties and requesting confirmation from adjusters and attorneys of the status of a selected number of cases in which the records indicate salvage or subrogation collections are a possibility.

Reported Losses. Listings of losses reported but unpaid and reinsurance recoverable thereon as at the statement date, including estimates of unpaid loss adjustment expenses when estimated on a case basis, should be obtained and tested for arithmetical

accuracy; totals should be traced to the financial statements. Open claim files should be examined on a test basis in support of the listed amounts. Final claim numbers included on the listings should be reviewed to determine the propriety of the cut off of reported losses. It should also be determined that previous estimates of recoverable amounts have been removed from loss estimates.

Where loss estimates are based on average costs a review should be made of the methods used in their determination, consideration being given to logic applied, trends over a period of years and whether volume is sufficient for results to be credible. Consideration should be given to the manner in which reinsurance recoverable is treated in the calculation of average costs, particularly where there is a substantial amount of reinsurance.

A comparison of loss statistics with those of the industry should be made. A review should also be made of the company's loss experience statistics for a period of years. Normally a development period of three to five years is needed to determine with reasonable accuracy the actual settlement costs of liability, workmen's compensation, fidelity and surety claims. The difficulty of accurately estimating the costs of settling outstanding claims is further complicated by long-range changes in the economy and the value of the dollar. In order to insure that the provision for outstanding claims will be adequate, it has generally been considered good practice to provide reserves that will exceed the actual expected developments by a nominal percentage. Any drastic change in the valuation of outstanding claims should serve as a warning that the estimating procedure should be investigated.

Unreported Losses. As explained previously, estimates for incurred but not reported losses are provided on the basis of past experience related to current exposure. Management frequently adds a safety margin to the estimates so developed.

Developed experience for incurred but not reported losses should be reviewed to determine the reasonableness of the company's estimates including tests of the propriety of percentages used and accuracy of computations.

Statutory Formula Reserves. The statutory requirements relating to the method of computing minimum reserves required by statute should be reviewed to determine that the company has complied with such requirements. Tests should be made of the details contained in the schedules supporting the amounts of such minimum reserves such as earned premiums, losses and loss expenses incurred, and premiums in force.

Unpaid Loss Adjustment Expenses. Where estimates for unpaid loss adjustment expenses have been established on a case basis, the auditing steps to be followed have been previously outlined under the caption "Reported Losses." Where such estimates have been established on a formula basis, the developed experience should be reviewed and tested to the underlying records, and the calculation and application of percentages should be checked. Comparison should also be made with experience statistics for prior years to determine whether the current developments appear to be reasonable and whether the methods used have been consistently applied.

Reinsurance Recoverable on Paid Losses. At year end a summarization of balances by reinsurer should be compared with the general ledger control account and the subsidiary records and test confirmation obtained.

Unauthorized Reinsurance Recoverable. The auditor should ascertain that appropriate recognition has been given to the requirement that reserves must be established for losses recoverable from reinsurance companies not authorized to do business in the various states to the extent that such losses exceed funds held or retained for the account of such companies. A list of all authorized companies is furnished in instructions issued by the insurance departments of some states. Funds held by or retained for account of unauthorized reinsurers should be confirmed.

Chapter 5

INVESTMENT OPERATIONS

Insurance statutes generally regulate the investments of insurance companies either by stating specifically which types of assets shall be included among "admitted assets" or by giving the supervisory authorities the power to pass upon the admissibility of assets, or both. Some state laws prescribe the types of bonds, stocks, and mortgages which may be acquired by the companies as well as the limitations on amounts of individual investments and aggregate classes of investments.

Investments of fire and casualty companies consist primarily of bonds and stocks. Some companies may also own mortgage loans. Real estate investments are generally restricted to office buildings and other facilities for company use.

Common practice in the industry is to reflect bonds at original cost reduced by amortization of premiums or increased by accretion for discounts. If the bond is in default, however, as to principal or interest, values published by the National Association of Insurance Commissioners must be used. Amortization is usually calculated by the scientific or straight line method; many states require the use of the scientific method (yield method). In the case of bonds purchased at a premium and which are subject to call before maturity, the premium should be amortized to maturity or an earlier call date, whichever results in the lesser amortized cost at the statement date.

Companies which record amortization on their records reflect amortization of the premiums and accrual of the discounts as an adjustment of interest income of the period. Some companies

do not record amortization on their records; amortization accordingly is reflected in unrealized appreciation or depreciation in their annual statements; upon sale or maturity of the bond the realized gain or loss is determined in relation to original cost.

Most stocks are reflected in the annual statement at values published by the National Association of Insurance Commissioners. These are based generally on market quotations but include dividends declared on stocks payable after December 31 which are quoted ex-dividend on that date. Stocks of subsidiaries are valued at the pro rata portion of their capital stock and surplus at the statement date. In determining surplus of noninsurance subsidiaries, assets and liabilities must be stated on the basis prescribed for insurance companies.

The admitted asset value for mortgage loans is generally equivalent to face amount, but for each loan it is generally limited to the greater of a prescribed amount or a fixed percentage of total admitted assets. Mortgage loans are only considered admitted assets if they are first liens on property.

The gain or loss resulting from the change during the year in the difference between book value and admitted asset value is reflected in the surplus account as unrealized capital gain or loss. Thus such gain or loss includes changes in the non-admitted portion of investments (the excess of book value over admitted asset value). Net realized capital gain or loss is shown in the investment section of the income statement.

Investment income from real estate may include rent on space occupied by a company in its own building. A contra charge is reflected in expense.

Interest, dividends and real estate income due and accrued reflected as an admitted asset includes dividends, if any, payable on or before the balance sheet date but which were not received; dividends payable in the subsequent period are not included in the accrual but, as stated above, are recognized in valuing stocks.

The excess of admitted asset value of investments over book value and interest, dividends and real estate income due and accrued are termed "non-ledger assets" since they are usually not recorded on the general ledger.

Outline of Auditing Procedures

The principal objectives in the audit of investments involve the establishment of ownership, the legality of the investment, the basis of valuation and the accounting for income and gains and losses. Schedules A, B and D of the annual statement provide a detailed listing of real estate, mortgages, and bonds and stocks, respectively, at the end of the year as well as details concerning acquisitions and disposals during the year and income earned on individual investments.

The legality of investment holdings should be checked by reference to applicable state laws.

Securities owned (and also securities held as collateral or as salvage) should be inspected or confirmed with custodians or other holders as of the audit date. Mortgage loans should be confirmed and documents tested.

Tests should be made of the amortization computations used in determining the valuation basis for bonds and consideration should be given to the need for a valuation allowance. The valuations for stocks may be compared with quotations listed in financial publications (allowing for the elimination of fractions and the inclusion of dividends on stocks quoted "ex-dividend"). The method of determining valuations for stocks of other insurance companies and for subsidiaries should be reviewed. The audit of investments in real estate involves the application of the usual steps associated with fixed assets.

Security transactions and interest and dividend income should be appropriately tested. Significant outside income from real estate investments should be tested by reference to source data and the reasonableness of rents for company occupied premises should be reviewed.

Chapter 6

SUNDRY UNDERWRITING AND INVESTMENT EXPENSES

Sundry underwriting and investment expenses, except for commissions based on premiums, are generally recorded on the cash basis of accounting and converted to the accrual basis at the end of the year.

Uniform Accounting Instructions for Expense Reporting

The handling of expenses for an insurance company becomes largely a matter of cost accounting. Each expense is required to be allocated by classification, administrative function, and line of business. This requirement is found in the uniform accounting instructions (called Regulation 30 in New York) which have been in effect for all states since January 1, 1950. The purpose of the uniform accounting instructions is to provide a consistent means of comparison between companies and years and to furnish a basis for rate study by state authorities. Its objective is to establish uniformity in the allocation of expenses by these principal groupings:

1. Basic operating expense classifications
2. Companies, if more than one insurance company is operated jointly
3. Functional expense groups
4. Lines of business

The principal bases for expense allocations are as follows:

1. All expenses which are incurred for a specific company, or for a specific function or line are allocated directly.

2. Expenses not directly allocable but related to certain direct expenses are allocated in the same proportion as the direct expenses to which they relate.
3. Expenses which are not related to any direct expense may be allocated on the basis of time studies or any other satisfactory method.
4. Expenses which are not subject to allocation based on time or special studies are to be allocated on the basis of premium volume or other reasonable basis.

Companies are required to maintain adequate records which substantiate the various allocations made.

After distribution to operating expense classifications, expenses are allocated to the following functional groups:

1. Investment expenses
2. Loss adjustment expenses
3. Acquisition, field supervision, and collection expenses
4. Taxes
5. General expenses

Commissions to Agents and Brokers

The commissions (other than contingent commissions) which companies agree to pay agents or brokers are based on a percentage of premiums. Commissions are an acquisition cost and are recorded as an expense at the time the related premiums are recorded, even though the premiums may apply to policies running longer than one year or expiring after the year end. The liability for unpaid commissions is netted against the asset "Agents Balances or Uncollected Premiums."

Contingent commissions result from agreements with agents and brokers whereby they are allowed additional commissions contingent upon favorable loss experience of the business they place with the company. There are many theories concerning the establishment of the provision for unpaid contingent com-

missions. One of the greatest difficulties arises because many contingent commissions are payable on a fiscal year basis rather than a calendar year basis. Some of the methods used in establishing this provision are:

1. Estimating amounts due on all contingent years closed during the current or prior years but not yet paid and making no provision for any contingent commissions that might be due on contingent years not yet closed.
2. The amounts developed under the first method plus the estimated amounts due at December 31 on contingent years not yet closed. This method appears to be more realistic than the first method as it results in a better matching of expenses and income and is certainly more conservative. However, for any company where a large number of agents receive contingent commissions on a fiscal year basis, it is not practical to actually compute all contingents and therefore they are estimated.
3. Many companies attempt to estimate this liability on an over-all basis based on past experience.

The independent auditor is, of course, concerned with the consistency of the basis for determining the reserve between years.

Commissions on Reinsurance

All reinsurance is contractual. Treaties set forth the commissions to be allowed to the ceding company, generally applicable only with respect to pro rata reinsurance. The commission is usually sufficient to reimburse the ceding company for its acquisition expenses, premium taxes and board, bureau and association expenses on the business reinsured. So that the ceding company may participate in the profits on reinsurance, the treaties frequently provide for commissions at a fixed rate plus a contingent commission or for commissions on a sliding scale. The commission rate under sliding scale commission arrangements is generally predicated on the loss and the loss expense ratio subject to a designated minimum rate; however, there is usually a

provision for the carry forward of any loss suffered by the reinsurer due to the application of such minimum rate.

On excess reinsurance, the premium is usually a percentage of the ceding company's net premiums for the class or classes of business reinsured and is generally not subject to commission.

Taxes (Other than Federal Income Taxes)

The principal tax in this category is called premium tax because it is based on premiums written within the borders of a taxing authority. The rate of this tax varies among states, usually ranging from 1½% to 4%. In some cases counties and municipalities also levy taxes based on premiums.

Federal Income Taxes

Fire and casualty insurance companies are divided into two categories for Federal income tax purposes, namely stock and mutual, to which special provisions apply. All provisions of the tax law not inconsistent with the special provisions are applicable to the taxation of such insurance companies. Accordingly, fire and casualty insurance companies provide accruals in the usual manner.

Other Expenses

Other unpaid expenses at the close of the year are accumulated by an inventory of bills on hand and unpaid, expenses incurred but unpaid, expenses accrued by reason of the running of time or by the application of contract or treaty.

Outline of Auditing Procedures

Commissions. As previously mentioned the checking of agents' and brokers' regular commissions should be undertaken in connection with the review of dailies.

Contingent commissions paid during the period should be tested. Agents' contracts should be reviewed to determine

whether contingent commissions were calculated in conformity with contracts; calculations should be tested. Supporting data as to premiums and losses should be tested.

The auditor should also determine with respect to reinsurance assumed and ceded that sliding scale commissions have been adjusted and contingent commissions have been calculated in accordance with the terms of the various treaties.

Taxes and Other Expenses. Tax returns should be examined on a test basis in support of payments and adequacy of accruals for the various state taxes and sufficient tests made to determine that the taxes have been properly calculated and the allocable credits taken. Federal income tax accruals should also be reviewed.

A representative group of invoices or vouchers should be selected for examination. The number of invoices and method of selection must be determined by the exercise of professional judgment in each particular case. However, it is important that all significant types of expenses be included.

The auditor should examine the company's records to determine that expense allocations are being made on a consistent basis and in keeping with the purpose of the uniform instructions issued by the regulatory bodies.

Tests should be made to determine that all liabilities are properly included at the close of the year on the annual statement. The auditor should test the calculations of those accruals that lend themselves to such treatment; other accruals should be reviewed as to reasonableness and the consistency of their development.

He should also determine that proper provision has been made for additional premiums on reinsurance ceded contracts on which deposit premiums were originally paid but which are subject to periodic adjustment. Reinsurance ceded on an excess of loss basis and catastrophe covers are usually subject to such adjustments.

Chapter 7

CAPITAL AND SURPLUS

The recognized concept as to the significance of capital and surplus in the insurance industry is best indicated by the caption used in the annual statements to describe total capitalization. This caption, "Surplus as regards policyholders," places the emphasis on solvency insofar as the policyholders are concerned and tends to subordinate the investors' viewpoint.

In the case of stock companies, the amount of capital stock required to be issued and maintained is governed by the respective state insurance laws. The law usually prescribes the minimum value of the shares that may be issued. In addition to the minimum capital stock requirements, there is a provision for the payment of an additional amount in the form of surplus equivalent to a prescribed per cent of the minimum capital stock.

In lieu of capital stock, mutual companies are organized with prescribed minimum surplus requirements which vary among states. Such surplus requirements may take the form of guaranty funds, guaranty capital, or other permanently designated funds subject to the payment of interest and subject to repayment under conditions prescribed by the respective state laws.

Typical surplus transactions, in addition to the gain or loss from operations, include several items peculiar to the insurance industry. These items consist of the following:

Net unrealized capital gains or losses

Unrealized capital gains or losses originate as a result of the prescribed method of valuation of investments. The change in the difference between book value and prescribed value occurring between reporting dates is charged or credited to surplus as unrealized capital gains or losses.

Changes in non-admitted assets

Certain assets are excluded from the balance sheet when reporting to the regulatory authorities.

Change in excess of statutory and voluntary loss reserves over case basis and loss expense reserves

It should be noted that adjustments to the case basis loss and loss adjustment expense estimates are accounted for in the statement of income.

Change in liability for unauthorized reinsurance

The various states require that a liability be carried for reinsurance recoverable from unauthorized reinsurers on account of unearned premiums or paid or unpaid losses to the extent that such reinsurance recoverable exceeds funds held or retained for account of such unauthorized companies. The increases or decreases during the period in the liability for unauthorized reinsurance are charged or credited to the surplus account.

Change in foreign exchange adjustment

Changes for the year in assets and liabilities due to foreign exchange rates.

Dividends to stockholders

Some state laws permit dividends to be paid out of surplus regardless of the source, so long as the minimum statutory surplus amount is maintained.

Outline of Auditing Procedures

Except for the need to check the statutory minimum capital and surplus requirements applicable to the lines of business written by the company, the audit of capital and surplus is similar in all respects to that of other industries.

In view of the tendency to accumulate all types of surplus in one account, it is frequently necessary to analyze the account as to sources of surplus. The applicable state laws should be reviewed to ascertain compliance with restrictions on surplus.

The validity and propriety of miscellaneous surplus items should be ascertained.

Chapter 8

NON-ADMITTED ASSETS

Non-admitted assets include all assets other than those permitted to be reported as admitted assets in the annual statement. The principal non-admitted assets are:

1. Excess of book value over investment value of bonds
2. Excess of book value over market value of stocks
3. Agents' balances or uncollected premiums over three months due
4. Equipment, furniture and supplies
5. Automobiles

Even though equipment, furniture, supplies and automobiles are classified as non-admitted assets, electronic equipment is, under certain circumstances, allowed as an admitted asset. Some companies charge equipment, furniture, supplies and automobiles to expense in the period of acquisition rather than treating them as non-admitted assets.

There are many other non-admitted assets which are usually not important as to total dollar amount. Those most frequently encountered are:

1. Bills receivable, past due, taken for premiums
2. Excess of bills receivable, not past due, taken for risks over the unearned premiums thereon.
3. Bills receivable, not taken for premiums

4. Loans on personal security, endorsed or not
5. Debit balances due from employees or fieldmen and other unsecured receivables
6. Company's stock owned
7. Loans on company's stock
8. Deposits in suspended banks, less estimated amount recoverable
9. Mortgage loans other than first liens and the excess of loan balances over appraised values of mortgaged premises
10. Funds held by or deposited with ceding reinsurers who are insolvent or in some states the excess of such funds over the liabilities to such ceding reinsurers
11. Leasehold improvements
12. That portion of equities in underwriting syndicates or associations representing non-admitted assets of such syndicates or associations

Most of the preceding non-admitted assets are self-explanatory. In general, receivables, except those acquired in the direct course of the business such as premium balances, premium notes or reinsurance recoverable on loss payments, are automatically classified as non-admitted assets unless they are collateralized.

Bills or notes receivable are utilized as a method of financing premiums, generally in those states or territories where installment premiums are not permitted or are not customary. There is a similarity to installment premiums in that the total of unpaid installments or the unpaid note balance is usually less than the unearned premiums which would be due the insured in the event of cancellation of the policy. Bills or notes receivable taken from insureds for premiums, if past due, are classified as non-admitted. The excess of the balance due on bills or notes not past due over the unearned premiums on the underlying policy or policies is also a non-admitted asset. All bills or notes receivable, except those taken from insureds for premiums or those fully secured by collateral, are also classified as non-admitted assets.

In many states insurance companies are not permitted to own their own stock. Loans on company stock, which generally arise from sale of stock to employees, are also classified as non-admitted assets.

Funds held by or deposited with ceding reinsurers are usually permitted to be reported as admitted assets. However, when the funds held are in excess of the liabilities of the reinsurer to the ceding company, such excess is classified as non-admitted. Funds held by or deposited with an insolvent company are also non-admitted.

Outline of Auditing Procedures

The auditing procedures applicable to many of the non-admitted assets were discussed previously.

Assets such as equipment, furniture, automobiles, leasehold improvements, bills or notes receivable not taken for premiums, loans on personal security, balances due from employees and fieldmen and other unsecured receivables, company's stock owned and loans on company's stock are frequently encountered by the auditor; consequently, the applicable auditing procedures will not be discussed here.

Bills or notes receivable taken from insureds for premiums should be test confirmed, selected notes should be examined and the detailed trial balance of notes should be test-checked and the total thereof agreed with the control account. A review should be made to determine that notes past due and the excess of note balances over unearned premiums on the underlying policies have been properly classified as non-admitted assets.

A review should be made to determine that funds held by insolvent ceding companies and funds held in excess of liabilities of the reinsurer to the ceding company have been properly classified as non-admitted assets.

Chapter 9

THE AUDITORS' REPORT

Insurance companies are required to report at least annually to the state agencies regulating the insurance business. Since the primary purpose of regulatory laws enacted by the various states has been the protection of policyholders, all of the statutes have as one of their principal underlying objectives the development and enforcement of measures concerned with the solvency of the individual company. Administration of these statutes has been vested in state insurance departments which prescribe the content and form of financial statements, known as the "annual statement," which have to be filed with these departments.

To comply with the reporting requirements of the regulatory authorities the companies must follow prescribed accounting practices which differ in some respects from generally accepted accounting principles followed by other business enterprises in determining financial position and results of operations.

Statements on Auditing Procedure No. 33 states that the basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to regulated companies, including insurance companies. This raises practical problems in audit reporting because the significance of the differences which may exist between these two bases has not in many cases been fully evaluated.

Representatives of the Institute have discussed the variances between prescribed insurance accounting practices and generally accepted accounting principles at great length with certain members of the insurance industry. The prescribed accounting prac-

tices considered to involve variances from generally accepted accounting principles are discussed in the following paragraphs, with the views of certain industry members in italics following each section.

Matching of Income and Expenses

One of the financial reporting practices which insurance companies must follow is that no recognition may be given to prepaid expenses or deferred charges. All costs, such as commissions, premium taxes and other items, in connection with writing insurance and obtaining premiums must be charged against income as they are incurred. Premiums, however, must be taken into earnings over the periods covered by the policies.

Accordingly, in a period of increasing premium volume, the results of statutory underwriting operations of a company are depressed to the extent of the expenses applicable to the increase in unearned premiums which will be reflected in income of later years. Conversely, in a period of declining premium volume statutory underwriting results are benefited by premiums taken into income whose related costs were charged against income in prior periods.

In most cases such costs allocable to unearned premiums are material in relation to total capital, and, in many companies, the change in such costs from one year to the next is material in relation to the statutory underwriting income.

Although it has long been customary in the insurance industry to estimate the resulting equity in unearned premiums (prepaid acquisition expenses applicable to unearned premiums) at 40 per cent for fire lines and 35 per cent for casualty lines, the amount in each individual company depends on several factors which must be investigated before a computation can be made. The tentative estimation of this equity should be based on that percentage, determined on significant lines or groups of lines of business, of the unearned premiums which the appropriate acquisition and related costs incurred during a representative historical period bear to the premiums written during that period. The percentage applied to unearned premiums in the tentative

estimation should generally not exceed the percentage derived by deducting from 100 per cent the sum of (i) the anticipated loss ratio, (ii) the anticipated loss expense ratio, and (iii) the anticipated ratio of expenses subsequent to acquisition. Determining anticipated loss, loss expense and general expense ratios usually requires an analysis of historical data for the company plus knowledge of other factors such as giving greater weight to the more recent loss experience and taking into account recent rate changes which would be reflected in the unearned premiums in the balance sheet. It would also be necessary to recognize the results of the related Federal income tax effect.

Certain members of the insurance industry do not concede that the existence of what the industry regards as conservatism in unearned premium reserves is necessarily ipso facto in conflict with generally accepted accounting principles appropriately applied to insurance business, nor is it conceded that an "asset" in the nature of prepaid expenses actually exists. They contend that the margin of conservatism in the unearned premium reserve liability is analogous to the margins of conservatism in the evaluation for other types of enterprises of a number of kinds of assets and liabilities. In any disclosure of the existence of this variation, it should be made clear that it arises from accounting methods which are prescribed by law.

Valuation of Investments

Stocks are, in general, carried at market or appraised values, which is an acceptable practice. However, no provision for income taxes is made with respect to unrealized appreciation on such investments.

Certain members of the industry are of the opinion that the absence of recognition in the financial statements of a potential tax with respect to unrealized appreciation is appropriate if, as in the case of most insurance companies, there is no realistic expectation of material amounts of tax becoming payable.

Capital Gains and Losses

The annual statement provides that realized gains or losses should be included in the determination of statutory net income.

In some instances, the gain on sales of investments far exceeds the other operating results and its inclusion in statutory net income has the effect of turning a substantial loss for the year into a profit. Furthermore, unrealized gains or losses resulting from periodic changes in the relationship of investment cost to market or other values (i.e., changes in unrealized appreciation or depreciation) are required to be recognized and treated as direct credits or charges, respectively, to surplus.

Certain members of the industry believe there is no single approach to the treatment of realized and unrealized capital gains which will simultaneously satisfy all of the requirements of informative reporting for insurance company operations. This being the case, adequate disclosure in financial reporting should be sufficient.

Non-admitted Assets

Non-admitted assets are required to be excluded from the annual statement without regard to their realizable or useful value. Furthermore, some companies charge equipment, furniture and automobiles to expense when purchased rather than treating them as non-admitted assets and charging depreciation to expense.

Certain members of the industry consider the accounting treatment accorded non-admitted assets to be a conservative approach and one that usually has no material effect on the financial statements.

Statutory Reserves

Insurance companies are required to maintain loss and loss expense reserves for certain types of risks at the higher of an amount determined by the use of a statutory formula or an amount determined by the company based on adjusters' estimates case by case plus company-determined formulas for certain classes of outstanding losses. Since the company's estimates are determined in the light of particulars of individual cases, and its experience with similar claims and current trends, they generally represent a more realistic measure of the losses which will have to be met than do reserves determined by statutory formula.

When a company deducts from its unearned premium reserve liability the unearned premium on reinsurance ceded by it, the state regulatory authorities may not recognize the propriety of such deduction unless the assuming company is authorized to do business in that state and hence is subject to its jurisdiction and regulation, or unless the deduction is backed by funds of the assuming company retained by the ceding company. The disallowance of such a deduction is reported in the statement of the ceding company by establishing a liability "unearned premiums on reinsurance in unauthorized companies . . . Less funds held or retained by company for account of such unauthorized companies . . ." Similar treatment is accorded to deductions from loss and loss expense reserves for reinsurance recoverable from "unauthorized" companies.

Certain members of the industry consider that the accounting treatment accorded the statutory reserves is conservative but not in conflict with generally accepted accounting principles.

Form of Opinion

The insurance laws of some states contain certain prohibitions against the publication by insurance companies of financial statements based on accounting practices differing from those used in preparation of the annual statement. However, such laws generally permit the inclusion in published reports of supplemental data to the annual statement.

As previously stated, Statements on Auditing Procedure No. 33 on page 70, in paragraph 38, states that "The basic postulates and broad principles of accounting comprehended in the term 'generally accepted accounting principles' which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (Such companies include . . . insurance companies . . . and the like.)" This conclusion raises practical problems in reporting on examinations of insurance companies because the significance of the differences which exist between prescribed insurance accounting practices and generally accepted accounting principles in many cases have not been fully evaluated

or resolved. To meet the requirements of Statement No. 33, it is generally necessary to provide supplemental data indicating the effect of the applicable variances between prescribed accounting practices and generally accepted accounting principles, as discussed in the preceding sections of this chapter, either in the form of notes to the financial statements or in appropriate supplemental schedules.

The need to supplement the statutory financial statements has long been deemed necessary by the independent public accountant in connection with registration of insurance companies' securities under the Securities Act. In connection with an SEC filing, the primary statements of assets and liabilities and income and surplus which are included are prepared in accordance with statutory requirements. In addition, supplemental information is given which reconciles capital stock equity and the income statement as presented with those as determined in accordance with generally accepted accounting principles. This practice, developed by the accountants, was formally adopted by the Securities and Exchange Commission in Accounting Series Release No. 89 announcing the adoption of the revised Article 7. The requirement as set forth in Regulation S-X is as follows:

> State in tabular form in a note or otherwise, together with appropriate explanation, a reconciliation of material differences between (a) capital share equity as reported on the balance sheet and capital share equity as determined in accordance with generally accepted accounting principles and practices, and (b) net income or loss as reported on the profit and loss or income statement and net income or loss as determined in accordance with generally accepted accounting principles and practices.

An independent auditor's opinion and the forms in which the required reconciling supplemental data may be presented as supplemental schedules are illustrated below. The suggested language and forms should, of course, be adapted to the particular circumstances.

> We have examined the Statement of Admitted Assets, Liabilities and Surplus of X Company at December 31, 19__, and the related Statements of Income and Changes in Surplus for the year then ended, together with the related supplemental State-

Statement of Adjusted Net Income

Net income (loss) as shown in the accompanying Statement of Income		$......
Adjustments [these will be added or deducted as appropriate]:		
Net realized gains or losses on investments [to segregate them from net income if so included]	$......	
Income taxes applicable to net realized gains or losses [to segregate from net income]	......	
Increase or decrease in acquisition costs applicable to unearned premiums [difference between amounts at beginning and end of the period]	......	
Difference between depreciation and cost of furniture, equipment, automobiles and leasehold improvements [if purchases are charged to expense]	......	
Future income taxes or reductions applicable to increase or decrease in acquisition costs [taking into account, with explanation, losses and loss carryovers on income tax basis]	......	......
Net income, as adjusted [excluding investment gains and losses]		$......
*Investment gains and losses**		
Net realized gain or loss	$......	
Less income taxes	......	$......
Increase or decrease in net unrealized gain or loss	......	
Less allowance for future income taxes	......	......
Net investment gain or loss		$......

*If amortization of bond premiums and discounts is not treated as an adjustment of interest income, the realized and unrealized gains and losses would require adjustment.

Policyholders' surplus as shown in the accompanying Statement of Admitted Assets, Liabilities and Surplus		$......
Adjustments [these will be added or deducted as appropriate]:		
Acquisition costs applicable to unearned premiums [at end of the period]	$......	
Unearned premiums and losses recoverable on reinsurance in unauthorized companies [total as shown among liabilities, if satisfied as to solvency of the unauthorized reinsurers]	......	
Excess of statutory and voluntary loss and loss expense reserves over case basis estimates [total as shown among liabilities, if satisfied that case estimates are adequate]	......	
Furniture, equipment, automobiles and leasehold improvements, less $...... depreciation and amortization [on income tax basis]	......	
Other non-admitted assets [if appropriate under generally accepted accounting principles and after appropriate allowance for losses, if needed—major items to be detailed]	......	
Income tax effects applicable to:		
Restoration of acquisition costs	......	
Net unrealized gain on investments	......	......
Stockholders' equity, (or members' surplus) as adjusted		$......
Consisting of:		
Capital stock		$......
Capital in excess of par value		......
Retained earnings:		
Appropriated for contingencies—prescribed or voluntary	......	
Unappropriated	......	
Unrealized appreciation of investments net of Federal income taxes	......	......
		$......

ment of Adjusted Net Income and Statement of Adjusted Stockholders' (Members') Equity. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying financial statements present fairly the admitted assets, liabilities and surplus of X Company at December 31, 19__, and the results of its operations and changes in surplus for the year then ended, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of (blank), applied on a basis consistent with that of the preceding year. These practices vary in some respects from generally accepted accounting principles (See Note 1 to financial statements).

Also, in our opinion, the supplemental Statements of Adjusted Net Income and Adjusted Stockholders' (Members') Equity present fairly the adjusted stockholders' (members') equity at December 31, 19__, and the adjusted net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

In those situations in which the supplemental data is included in a footnote rather than in supplemental statements, the last sentence of the auditors' opinion would read as follows:

Also, in our opinion, the supplemental data included in Note__ present fairly the adjusted stockholders' (members') equity as of December 31, 19__ and the adjusted net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

In those instances where the effects of the variances have not been determined by the insurance companies and are not reasonably determinable, the committee believes that the following independent auditors' opinion is illustrative of one that will substantially meet the objectives of Statement No. 33.

We have examined the Statement of Admitted Assets, Liabilities and Surplus of XYZ Insurance Company as at December 31, 19__ and the related Statements of Income and Changes in Surplus for the year then ended. Our examination was made in

accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying financial statements present fairly the admitted assets, liabilities and surplus of XYZ Insurance Company at December 31, 19__, and the results of its operations and changes in surplus for the year then ended, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of (blank), applied on a basis consistent with that of the preceding year. These practices vary in some respects from generally accepted accounting principles (See Note 1 to financial statements).

An illustration of Note (1) as it might appear is as follows:

Notes to Financial Statements

(1) The accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of (blank) which vary in some respects from accounting principles followed by business enterprises in general in determining financial position and results of operations. Such significant differences include:

(a) No provision has been made for Federal income taxes on unrealized appreciation of stocks which are carried at market value; (b) acquisition costs, such as commissions, premium taxes and other items, are charged to current operations as incurred, whereas related premium income is taken into earnings on a pro rata basis over the periods covered by the policies; (c) certain assets designated as "non-admitted assets" (principally direct and reinsurance premiums "overdue," and office furniture and equipment) are charged off against income or surplus; (d) reserves are provided over related funds held for the excess of unearned premiums and losses recoverable on business reinsured with companies not authorized to do business in the state; (e) on certain lines of insurance reserves in excess of the amounts considered adequate by the company have been provided in accordance with statutory requirements, and (f) realized investment gains and losses are included in net income from operations, while unrealized gains and losses are credited or charged directly to surplus.

The effect of such differences on the accompanying financial statements is not reasonably determinable (or, as an alternative

to the words "on the accompanying financial statements," on the stockholders' equity and net income).

It should be emphasized that the items mentioned in this Note are included only for purposes of illustration. In a particular case, some of the items may not apply, or others may be applicable. Any items mentioned in a note as representing differences between the two bases of accounting should have application in the particular case.

In those cases where supplemental statements are furnished, the following sentence should be included:

> The effect of the variance referred to above is shown in the accompanying supplemental Statements of Adjusted Net Income and Adjusted Stockholders' (Members') Equity.

In those cases where the supplemental data is to be included in the note, the concluding paragraph of Note (1) may read:

> If the accompanying financial statements had been prepared in accordance with generally accepted accounting principles, Earned Surplus at December 31, 19___, would be $________; total Stockholders' Equity would be $________; and Net Income for the year would have been $________.

In the above situation, of course, no reference would be made in the scope paragraph to supplemental statements.

In connection with filings with the SEC, the data must be included in tabular form in a note or otherwise, as indicated previously.

GLOSSARY of TERMS
FIRE and CASUALTY INSURANCE

ABSTRACT—Form prepared containing basic data shown on the policy. Copies of the abstract may be used by the accounting, statistical, payroll audit and inspection departments.

ACCIDENT YEAR—The calendar year in which the accident or loss occurred.

ACCOUNT CURRENT OR AGENT'S ACCOUNT—A statement usually prepared by the agent for his month's business showing for each premium transaction: the policy number, sometimes the insured's name, the premium or return premium in the appropriate column according to rate of commission, postage and other charges and the balance due either to the company or to the agent.

ACCRUAL OF DISCOUNT ON BONDS—Adjustment of the purchase price of bonds (purchased at less than par value) to increase the value to par at maturity date. The adjustment is either calculated on a pro rata basis or so as to yield the effective rate of interest at which the purchase was made (scientific basis).

ACQUISITION COSTS—Expenses incurred in acquiring business includes commissions to agents and brokers and other acquisition, field supervision and collection expenses. Usually also considered to include premium taxes.

ADDITIONAL PREMIUM—Premium due from the insured arising from an endorsement.

ADMITTED ASSETS—See Assets, admitted.

AGENCY COMPANY—An insurance company whose business is produced through a network of agents as distinguished from a direct writing company whose business is produced by company employees.

AGENCY REINSURANCE—Reinsurance assumed or ceded for an insurer by one of its agents who usually handles the details of writing the policies and collecting or paying the premiums. For example, on very large risks the agent frequently issues only one policy to the insured and then obtains reinsurance from other companies to reduce the exposure of the insurer to a desired level.

AGENCY SYSTEM—System of producing business through a network of agents. Such agents have a contract to represent the company and are of three classes: local, regional and general. These agents are compensated at differing rates of commission and general agents have much greater responsibilities and duties than local and regional agents.

AGENTS' BALANCES—Premium balances, less commissions payable thereon, due from agents and brokers.

AGGREGATE EXCESS OF LOSS—Stop loss agreement designed to prevent the ceding company's loss from exceeding a specific predetermined limit. For example, if under an agreement indemnifying a company against losses in excess of a 70 per cent loss ratio, the ceding company's loss ratio exceeds 70 per cent, then recovery will be made from the reinsurer of the necessary amount to reduce the loss ratio to 70 per cent.

ALLOCATED CLAIM OR LOSS EXPENSES—See claim or loss expenses.

AMORTIZATION OF PREMIUMS ON BONDS—Adjustment of the purchase price of bonds (purchased at more than par value) to decrease the value to par at maturity or call date. The adjustment is either calculated on a pro rata basis or so as to yield the effective rate of interest at which the purchase was made (scientific basis).

ANNUAL PRO RATA—A basis used for calculation of unearned premiums involving the assumption that the average date of issue of all policies written during the year is the middle of the year.

ANNUAL STATEMENT (CONVENTION STATEMENT OR CONVENTION FORM)—Statement furnishing full and complete information regarding the company's condition and affairs at December 31 of each year re-

quired by Insurance Departments of the various states in which a company is authorized to transact business. This annual statement must be filed on the prescribed form with the various Insurance Departments by March 1 of the following year.

APPLICATION—Request for insurance submitted to the insurer by or on behalf of the insured. The application usually includes sufficient facts for the insurer to determine whether or not it wishes to accept the risk. In some lines of insurance the terms daily and application are used synonymously.

ASSETS, ADMITTED—Assets stated at values at which they are permitted to be reported in the annual statement filed with the various Insurance Departments.

ASSETS, LEDGER—Assets which are recorded on a company's general ledger. Usually include investments, cash, agents' balances or uncollected premiums and reinsurance recoverable.

ASSETS, NON-ADMITTED—Assets, or portions thereof, which are not permitted to be reported as admitted assets in the annual statement filed with the various Insurance Departments. Non-admitted assets are those specifically defined by the insurance laws of the various states and also all other assets not allowed as admitted assets. Major non-admitted assets are: excess of book over statement value of investments, agents' balances or uncollected premiums over three months due and furniture, fixtures, supplies, equipment and automobiles.

ASSETS, NON-LEDGER—Assets which are not recorded on a company's general ledger. Usually include excess of statement value of stocks and bonds respectively over book value and accrued interest or other accrued income on investments.

ASSURED OR INSURED—The person whose life or property is insured. The party in whose favor a policy stands.

AUDIT PREMIUMS—Earned premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. Such audits are made and such reports are submitted either monthly, quarterly, semi-annually or annually.

AUTOMATIC TREATY—Usually a pro rata reinsurance treaty under which the reinsurer is committed to accept from the ceding company a

fixed share of each risk or of certain risks. Each party has a fixed obligation; the ceding company is obligated to cede and the reinsurer is obligated to accept.

BORDEREAU—Detailed listings of premiums and/or loss transactions usually prepared monthly and rendered to interested parties. Frequently rendered by ceding companies to reinsurers and by large general agents to companies.

BROKER—A licensed representative who places the insurance of his client with a company. The compensation for his services consists of commission paid to him by the insurance company. He is not an agent of the company and the commission he receives is usually lower than that of an agent who legally represents the company.

CANCELLATION—A complete termination of an existing policy prior to expiration.

CASE BASIS—Reserves for losses (claims) or loss expenses based on individual estimates of the value of each unpaid loss (claim).

CASE RESERVE—The estimated amount of future loss payments which are still to be made on an outstanding claim.

CATASTROPHE—Conflagration, earthquake, windstorm, explosion and other similar events resulting in substantial losses. Catastrophe losses (the whole loss of an insurance company arising out of a single catastrophic event) are usually reinsured under excess of loss treaties in order to limit any one such loss to a specific dollar amount.

CEDING COMPANY—The original or primary insurer who reinsures with another company who is called the reinsurer.

CESSION—The unit of insurance passed on to the reinsurer by the primary or ceding company. Frequently, under certain types of reinsurance treaties, each transaction is given a number called a cession number.

CLAIM OR LOSS EXPENSES—The expenses incurred in the investigation, adjustment and settlement of losses. There are two types of claim or loss expenses: allocated and unallocated; however, there are no generally accepted definitions of these two terms. Allocated claim or loss expense is frequently considered to include expenses in-

curred in settling losses that can be attributed to specific losses including such items as actual court costs, attorneys' fees, medical examinations, independent adjusters' fees, etc.

Unallocated claim or loss expense is frequently considered to include expenses incurred in settling losses which cannot be attributed to specific cases including salaries of company loss department employees and all other direct and overhead expenses of the loss department.

CLAIM OR LOSS FILES—All data relating to each loss or claim are placed together in a folder or stapled together, etc., and are referred to as the loss or claim file.

CLAIMS (LOSSES)—Synonymous terms. Death, injury, destruction, or damage in such a manner as to charge the insurer with a liability under the terms of a policy. The primary reason for the existence of insurance carriers is to pay claims and/or losses arising from the contingencies insured against.

CONTINGENT COMMISSION—A profit-sharing commission which is paid or received in addition to the ordinary basic commission. The amount of profit is calculated in accordance with the terms of the contract which usually provides that the earned premiums for the period be reduced by incurred losses and commissions and a stipulated allowance for expenses. The contingent commission is calculated at a percentage of such profit.

CONTRIBUTIONS TO PREMIUM IN FORCE—Net change in premiums in force for the period. Net original premiums written during the period (total original premiums less original return premiums).

CONVENTION STATEMENT OR CONVENTION FORM—See annual statement.

DAILY REPORT OR DAILY—The copy of the policy retained by the company or forwarded to the company by the agent. The daily does not include all of the standard provisions included in the policy, as this is unnecessary, but all special provisions and endorsements are attached to the daily. This is, of course, one of the basic documents in an insurance office.

DEVELOPMENT (RUN-OFF) OF LOSS RESERVES—Comparison of the loss reserves outstanding at any particular date with the total of the payments on such losses from the reserve date to the development date plus the estimated reserves for losses still unpaid at the date of the development.

DIFFERENCES—Term applied to the differences developed as a result of comparisons made of "accounts current" rendered by agents with transactions shown on the company's records. Such differences very frequently occur because the agent and the company each use a different cutoff date and also because of errors and omissions by either the company or the agent.

DIRECT PREMIUMS—All premiums (less return premiums) arising from policies issued to provide the primary insurance on a given hazard.

DIRECT WRITING COMPANY—An insurance company whose business is produced by company employees as distinguished from an agency company whose business is produced by agents.

EARNED PREMIUM—The pro rata portion of the premium applicable to the expired period of the policy.

ENDORSEMENT—Documentary evidence of a change in an existing policy resulting in either an additional premium, a return premium or no premium adjustment.

EQUITY IN THE UNEARNED PREMIUM RESERVE—Prepaid acquisition expenses applicable to unearned premiums. Pursuant to accounting practices prescribed for insurance companies, premiums are recorded as earned ratably over the terms of the policies issued although related commissions, premium taxes and other acquisition expenses are charged to income as incurred. This departure from the basic accounting concept of matching income and expense results in an equity in unearned premiums at any date to the extent of the prepaid acquisition expenses applicable to such unearned premiums. There is another concept concerning the equity in the unearned premium reserve based on the premise that the unearned premium reserve exceeds the amount required to pay future losses and expenses on all unexpired policies; under this concept any anticipated profit on the run off of the unexpired policies is included in the equity.

EXCESS OF LOSS TREATY—A type of reinsurance treaty used extensively on casualty lines and, to an increasing extent on fire lines, providing that the reinsurer pays all, or a specified percentage, of a loss arising from a particular occurrence or event (frequently of a more or less catastrophic nature) in excess of a fixed amount and up to a stipulated limit. Such treaties do not usually apply to specific

policies but to aggregate losses incurred under all policies subject to the particular hazards reinsured. The premium is usually a percentage of the net premiums written by the carrier for the hazards subject to such reinsurance.

FACULTATIVE—Reinsurance arrangements under which each risk to be reinsured is offered to and is either accepted or rejected by the reinsurer. So called facultative reinsurance arrangements are therefore only permissive and do not obligate the ceding company to cede or the reinsurer to accept.

FUNDS HELD BY COMPANY UNDER REINSURANCE TREATIES—A liability account used in connection with reinsurance agreements. When a company obtains a deposit from a reinsurer or withholds a portion of the premiums due as a guarantee that a reinsurer will meet its loss and other obligations, then this account is used to record such liability.

FUNDS HELD BY OR DEPOSITED WITH CEDING REINSURERS—An asset account used in connection with reinsurance agreements. The reinsurer uses this account to record deposits made with ceding companies or withholdings by ceding companies of a portion of premiums due as a guarantee that the reinsurer will meet its loss and other obligations. This account is also used when pools and associations withhold funds from reinsurers for the same purposes mentioned above and then the member companies use this asset account and the liability account, "Funds held by company under reinsurance treaties" to record this information on their books.

GROSS IN FORCE—Aggregate premiums from all policies on direct and assumed business recorded prior to the specified date which have not yet expired or been canceled.

GROSS NET PREMIUM INCOME—As used in reinsurance contracts, gross written premiums less return premiums and reinsurance premiums. This term has the same meaning as "net written premiums" or "net premiums" in the United States. In Europe the term "net premiums" refers to gross premiums received less return premiums, reinsurance premiums and commissions paid thereon.

GROSS PREMIUMS—Following annual statement usage, direct premiums plus reinsurance assumed premiums (both net of return premiums). Also defined as: premiums written or received but before deduction of return premiums.

HAZARD—The risk or peril or source of risk insured against. This term is frequently used interchangeably with the terms risk and peril.

INCURRED LOSS RATIO—Ratio calculated by dividing incurred losses by earned premiums.

INCURRED LOSSES (CLAIMS)—Losses paid or unpaid for which the company has become liable during the period. Incurred losses for a period are calculated by adding unpaid losses at the end of the period to losses paid during the period and subtracting unpaid losses at the beginning of the period.

INSTALLMENT PREMIUMS—Premiums payable on a periodic basis rather than in a lump sum at the inception or effective date of the policy.

INSURABLE VALUE—The stated value in the insurance contract. It may be the cash or market value, the declared value or the replacement value.

INSURANCE EXPENSE EXHIBIT—A supplement to the annual statement to be filed with each Insurance Department usually by May 1 rather than on March 1, the day on which the annual statement is due to be filed. The net gain or loss from underwriting for each line of business written by the company during the year reported on is shown on this exhibit.

INTER-INSURANCE EXCHANGE OR RECIPROCAL—An unincorporated aggregation of individuals or firms called subscribers who exchange insurance through an attorney in fact. Each subscriber is therefore both an insurer and an insured.

INTERMEDIARY—A reinsurance broker who negotiates reinsurance contracts on behalf of the reinsured (ceding company) with the reinsurer.

INVESTMENT EXPENSES—According to the uniform expense regulation, all expenses incurred wholly or partially in connection with the investing of funds and the obtaining of investment income.

LIABILITIES, LEDGER—Liabilities recorded on the company general ledger.

LIABILITIES, NON-LEDGER—Liabilities not recorded on the company general ledger but available from other basic records or sources.

Usually include accruals or provisions for unearned premiums, unpaid losses, loss expenses, contingent commissions, taxes, other expenses, dividends declared and unpaid, statutory loss reserves and unauthorized reinsurance.

LINE—Type of insurance. In relation to the amount which an insurance company accepts on a risk: (1) the limit which a company has fixed for itself as maximum exposure on a class of risk, (2) the actual amount which the company has in fact accepted on a single risk.

LOSS OR CLAIM EXPENSES—See claim or loss expenses.

LOSS OR CLAIM FILES—See claim or loss files.

LOSS RATIOS—Expression in terms of ratios of the relationship of losses to premiums. Two ratios in common usage are: (1) paid loss ratio—paid losses divided by written premiums or earned premiums, (2) incurred loss ratio—incurred losses divided by earned premiums.

LOSSES (CLAIMS)—See claims.

LOSSES INCURRED BUT NOT REPORTED (IBNR)—Losses resulting from accidents or occurrences which have taken place but on which the company has not yet received notices or reports of loss.

LOSSES OR CLAIMS INCURRED—See incurred losses (claims).

LOSSES OUTSTANDING (ALSO REFERRED TO AS LOSS RESERVE)—The estimated amount of unpaid losses for which the company is liable.

LOSSES, REPORTED—Losses resulting from accidents or occurrences which have taken place and on which the company has received notices or reports of loss.

MONTHLY PRO RATA—A basis used for calculation of unearned premiums involving the assumption that the average date of issue of all policies written during any month is the middle of that month.

MUTUAL COMPANY—Co-operative nonprofit association of persons whose purpose is to insure themselves against various risks.

NET PREMIUMS—Premiums written or received on direct and assumed business less return premiums and less reinsurance ceded premiums.

NON-ADMITTED ASSETS—See assets, non-admitted.

NON-LEDGER ASSETS—See assets, non-ledger.

NON-LEDGER LIABILITIES—See liabilities, non-ledger.

ORIGINAL PREMIUM—The premium for the full term of the policy. In case the policy has been changed, then the original premium can be determined by multiplying the amount currently insured by the latest premium rate shown on the policy or an endorsement thereof.

PAID LOSSES—Actual disbursements for losses during the period.

PERIL—Classification of loss occurrences insured against, such as fire, windstorm, collision, hail, bodily injury, property damage, loss of profits, etc.

POLICY DIVIDENDS—Payments made or credits extended to the insured by the company, usually at the end of the policy year, which result in reducing the net insurance cost to the policyholder. Such dividends may be paid in cash to the insured or applied by the insured as a reduction of the premium due for the next policy year.

POLICYHOLDERS' SURPLUS (SURPLUS AS REGARDS POLICYHOLDERS)—The total capital funds as shown on the annual statement. Consists of capital, if any, unassigned funds (surplus) and any special surplus funds which are not in the nature of liabilities.

POLICY YEAR—The calendar year in which a policy became effective.

POOLING—Practice of sharing all business of an affiliated group of insurance companies between the members of the group. All premiums written by the subsidiary companies are customarily ceded to or reinsured by the parent company; then, after provision for any required outside reinsurance, the total premiums are in turn ceded back to the subsidiaries in agreed ratios. Losses, loss expenses, commissions and other underwriting and operating expenses (excluding investment expenses) are similarly treated with the net result that each of the members of the affiliated group will share in the total business of the group (but usually in varying percentages) and all will achieve similar underwriting results.

PREMIUM—The consideration paid for a contract of insurance.

PORTFOLIO REINSURANCE—Reinsurance on a bulk basis. Occurs frequently at the inception or termination of a reinsurance treaty. Also used as a means by which a company may retire from a particular agency or territory or from the insurance business entirely. All business in force of the type, line or class which the company desires to reinsure is reinsured at a particular moment of time usually by the payment of the unearned premium reserve to the reinsurer less an agreed commission. The reserve for unpaid losses at the time of the transaction may also be paid over to the reinsurer and the reinsurer will then be charged with all loss payments made after the effective date.

PREMIUM EARNED—See earned premiums.

PREMIUM TAXES—Taxes levied, at rates varying from 1½ per cent to 4 per cent, on insurance companies by the various states on premiums written.

PREMIUMS IN FORCE—Aggregate premiums from all policies recorded prior to the specified date which have not expired or been canceled.

PROOF OF LOSS—A sworn statement furnished by the insured to the carrier setting forth the amount of loss claimed. This form, which is usually used in the settlement of first-party losses, includes the date and description of the occurrence, amount of loss claimed, interested insurers, etc.

PRO RATA REINSURANCE—The reinsured and the reinsurer participate in the premiums and losses on every risk that comes within the scope of the agreement at a fixed and certain proportion.

QUOTA SHARE REINSURANCE—A form of pro rata reinsurance. A reinsurance of a certain percentage of all the business or certain classes of or parts of the business of the reinsured. For example, a company might reinsure under a quota share treaty 50 per cent of all of its business or 50 per cent of its automobile business.

RECIPROCAL OR INTER-INSURANCE EXCHANGE—See inter-insurance exchange or reciprocal.

REINSURANCE—A contract in which the reinsurer (the first party) in consideration of a premium agrees to indemnify the reinsured (the second party) against a risk insured by the reinsured under a policy in favor of the insured (a third party). The reinsured may be

referred to as the original or primary insurer or the ceding company.

REINSURANCE ASSUMED PREMIUMS—All premiums (less return premiums) arising from policies issued to assume the liability, in whole or in part, of another insurance company which is already covering the risk with a policy.

REINSURANCE, AUTHORIZED—Reinsurance placed with companies authorized to transact business in the state of filing.

REINSURANCE, UNAUTHORIZED—Reinsurance placed with companies not authorized to transact business in the state of filing.

REINSURANCE CEDED PREMIUMS—All premiums (less return premiums) arising from policies or coverage purchased from another insurance company for the purpose of transferring the liability, in whole or in part, assumed from direct or reinsurance assumed policies.

REINSURANCE IN FORCE—Aggregate premiums on all reinsurance ceded business recorded prior to the specified date which have not yet expired or been canceled.

RETURN PREMIUM—A premium refund due the insured, arising from an endorsement or cancellation.

RETENTION—The net amount of any risk which a company keeps for its own account.

RETROCESSION—A reinsurance of reinsurance assumed. For example: A accepts reinsurance from B and then in turn reinsures with C a whole or part of the reinsurance assumed from B. The reinsurance ceded to C by A is called a retrocession.

RETROSPECTIVE PREMIUM—Premium determined after expiration of the policy based on the loss experience under the policy. The original premium charged on such policies is referred to as the standard premium.

RISK—See hazard.

STATUTORY LOSS RESERVES—The amount by which reserves required by law on bodily injury and workmen's compensation losses exceed the case basis loss and loss expense reserves carried by a company for such losses.

SALVAGE—Amount received by an insurer from the sale of property (usually damaged) on which he has paid a total loss to the insured. For example, when an insurer has paid the insured the actual cash value of an automobile damaged (usually extensively) by collision, then the insurer takes title to and sells the damaged automobile for his own account. Salvage is applied by insurance companies to reduce the amount of loss paid.

SPREAD LOSS TREATY—A treaty on an excess of loss basis designed to pay certain losses over a given or stipulated amount and to average such losses out over a period of years. Five years is the usual period, with the premium adjustable within fixed minimum and maximum limits according to the company's experience. Such a treaty protects the ceding company against shock losses and spreads their cost over a five-year period subject, of course, to the maximum and minimum premium each year.

STATUTORY—Relating to the laws of the federal or of a state government.

STOCK COMPANIES—Corporations organized for profit to offer insurance against various risks.

STOP LOSS REINSURANCE—Type of excess reinsurance also called excess of loss ratio. Provides that the insurer will suffer the loss in its entirety until the total amount of the loss is such that the loss ratio (losses divided by premiums) exceeds an agreed loss ratio, then the reinsurer will reimburse the insurer the sum that is necessary to bring the loss ratio down to the agreed percentage.

SUBROGATION—The statutory or legal right of an insurer to recover from a third party who is wholly or partially responsible for a loss paid by the insurer under the terms of a policy. For example, when an insurer has paid the insured for loss sustained to his automobile as the result of a collision, the insurer may collect through the process of subrogation from the person whose automobile caused the damage. Subrogation recoveries are treated as reductions of the losses paid.

SURPLUS AS REGARDS POLICYHOLDERS—See policyholders' surplus.

SURPLUS TREATY REINSURANCE—A treaty on a pro rata basis reinsuring surplus liability on various risks. The reinsurer shares the gross lines of the ceding company. The amount reinsured varies with dif-

ferent classes of risks and according to the net retention which the ceding company wishes to retain for its own account. Ceding companies very frequently have several layers of surplus treaties so that they may accommodate very large risks, as usually the reinsurer's participation in any one surplus treaty is limited to a certain multiple of the ceding company's retention. Premiums and losses are shared by the reinsurer and the ceding company on a pro rata basis in proportion to the amount of the risk insured or reinsured by each. This is one of the oldest forms of treaty reinsurance and is still in common use in fire reinsurance.

TREATY—A contract of reinsurance.

UNALLOCATED CLAIM OR LOSS EXPENSE—See claim or loss expenses.

UNEARNED PREMIUM—The pro rata portion of the premium in force applicable to the unexpired period of the policy term.

UNEARNED PREMIUM RESERVE—The estimated aggregate amount an insurer would be obligated to pay policyholders as return premiums for the unexpired terms of policies, if it should cancel every policy in force.

UNDERWRITING—The assumption of risk for designated loss or damage on consideration of receiving a premium. Usually also considered to embrace the determination of the acceptability of risks to be insured and of the proper premium therefor.

APPENDIX A

Statement of Position

Revision of Form of Auditor's Report

AUDITS OF FIRE AND CASUALTY INSURANCE COMPANIES

July 1974

Issued by Auditing Standards Division
American Institute of Certified Public Accountants

NOTICE TO READERS

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA task forces may from time to time conclude that it is desirable to change a guide. A Statement of Position is used to revise or clarify certain of the recommendations in the guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA task force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the task force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the task force believes would be in the public interest.

Insurance Auditing Task Force

RANDOLPH H. WATERFIELD, JR., *Chairman*
CORMICK L. BRESLIN
FRANK A. BRUNI
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PAUL W. HORSLEY
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RICHARD J. SENNEFF
RICHARD D. WAMPLER II

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JAMES M. CASEY

Audits of Fire and Casualty Insurance Companies

The AICPA issued in 1966 the industry audit guide, *Audits of Fire and Casualty Insurance Companies.* Chapter 9 of that guide included recommendations on the form of the auditor's report. In December 1972, the AICPA issued an industry audit guide entitled *Audits of Stock Life Insurance Companies.* The recommendations on the form of the auditor's report in that guide varied from the recommendations set forth in the fire and casualty audit guide. It is the considered judgment of the AICPA Insurance Auditing Task Force that the portion of chapter 9 on pages 58 through 64 of the fire and casualty audit guide that deals with the form of the auditor's opinion should be revised; that portion is superseded by this Statement of Position.

The preferable method of financial statement presentation to avoid the need for qualification of the auditor's report is to present the financial statements in accordance with generally accepted accounting principles.

When the financial statements of fire and casualty insurance companies, used for purposes other than filing with regulatory authorities, have been prepared in conformity with regulatory practices, the independent auditor should follow the requirement of section 544.02 of SAS No. 1 that—

> . . . material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or an adverse opinion on such statements. However, an adverse opinion may be accompanied by . . . [an opinion] . . . on any supplementary data fur-

nished which are fairly presented in conformity with generally accepted accounting principles.

Independent auditors' reports which might be used are illustrated below.

Effects of Variances From Generally Accepted Accounting Principles Have Been Determined

Qualified Opinion. When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of the variances from generally accepted accounting principles are sufficiently material to require a qualified opinion, the auditor's report might be worded as follows:

> We have examined the balance sheet of X Company as of December 31, 19__, and the related statements of income, changes in surplus and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> The Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ________. The effects on the accompanying financial statements of the variances between such practices and generally accepted accounting principles are described in Note X.[1]
>
> In our opinion, except for the effects of the matters referred to in the preceding paragraph, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19__, and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

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[1] If the effects of the variances are not described in a note, they should be set forth in this paragraph.

If a statement of changes in financial position on a statutory basis is not presented, the omission should be dealt with in accordance with sections 545.04 and .05 of SAS No. 1.

Adverse Opinion. When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of the variances from generally accepted accounting principles are so material that, in the independent auditor's judgment, a qualified opinion is not justified, an adverse opinion will be required. The adverse opinion will usually be followed by an opinion on any supplementary data presented in conformity with generally accepted accounting principles. When such data are presented separately, rather than in notes to the financial statements, the scope paragraph of the independent auditor's report should be expanded to include references to supplementary data and a second paragraph should be added referring to the variances from generally accepted accounting principles worded as in the prior example. The opinion paragraph might be worded as follows:

> It is our opinion that, because of the materiality of the effects of the differences between generally accepted accounting principles and the accounting practices referred to in the preceding paragraph, the aforementioned financial statements do not present fairly the financial position of X Company at December 31, 19__, or the results of its operations or changes in its financial position for the year then ended, in conformity with generally accepted accounting principles. It is our opinion, however, that the statements of adjustments to arrive at stockholders' (members') equity and net income present fairly stockholders' (members') equity at December 31, 19__, and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

When the supplementary data are included in a note to the financial statements, the last sentence of the opinion would read as follows:

> It is our opinion, however, that the supplementary data included in Note X present fairly the stockholders' (mem-

bers') equity at December 31, 19___, and net income for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Variances Not Affecting All Financial Statements. When the effects of variances from generally accepted accounting principles are material to one or more but not all of the financial statements, the auditor's report may include an unqualified opinion on the statements not so affected.

Effects of Variances From Generally Accepted Accounting Principles Have Not Been Determined

When the financial statements of a fire and casualty insurance company have been prepared in conformity with regulatory practices, and the effects of variances from generally accepted accounting principles have not been determined by the company, the auditor should generally be able to reasonably estimate whether such effects (a) would be immaterial so as to permit issuance of an unqualified opinion, (b) would be sufficiently material to require issuance of a qualified opinion, or (c) would be so material as to require issuance of an adverse opinion. In reporting, the auditor should then follow the appropriate form recommended above. If the auditor is not able to reasonably estimate the effects of variances, he should disclaim an opinion; his report might read as follows:

(Standard scope paragraph)

The Company presents its financial statements in conformity with the accounting practices prescribed or permitted by the Insurance Department of the State of __________. The variances between such practices and generally accepted accounting principles are described in Note X.[2] The effects of such variances on the accompanying financial statements have not

[2] If the variances are not described in a note to the financial statements, they should be set forth in this paragraph.

been determined. Therefore, we do not express any opinion on the aforementioned financial statements as to fair presentation of financial position or results of operations or changes in financial position in conformity with generally accepted accounting principles.

Opinions on Presentations in Conformity With Regulatory Practices

Section 544.04 of SAS No. 1 states that—

> In instances where the financial statements of regulated companies purport to be primarily presentations in accordance with prescribed accounting regulations, the independent auditor may also be asked to report upon their fair presentation in conformity with such prescribed accounting. There is no objection to the independent auditor's report containing such an opinion provided that the first standard of reporting is also observed by the issuance of a qualified or adverse opinion, as required by the circumstances.

When the auditor is asked to report in this manner, he may do so by adding the following opinion to the concluding paragraph of any prior examples:

> It is our opinion, however, that the aforementioned financial statements present fairly the financial position of X Company at December 31, 19__, and the results of its operations and changes in its financial position for the year then ended in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of __________, applied on a basis consistent with that of the preceding year.

Effective Date

The Insurance Auditing Task Force recommends that the foregoing reporting be applied with respect to auditors' reports on financial statements of fire and casualty insurance companies for periods ending after September 30, 1974, and encourages earlier application.

APPENDIX B

Statement of Position 78-6

ACCOUNTING FOR PROPERTY AND LIABILITY INSURANCE COMPANIES

July 28, 1978

Proposal to the
Financial Accounting Standards Board
to Amend AICPA Industry Audit Guide
Audits of Fire and Casualty Insurance Companies

Issued by Accounting Standards Division
American Institute of Certified Public Accountants

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1211 Avenue of the Americas, New York, N.Y. 10036

NOTICE TO READERS

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and, in some instances, on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA subcommittees or task forces may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA subcommittee or task force.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee or task force.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee or task force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the subcommittee or task force believes would be in the public interest.

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

July 28, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting for Property and Liability Insurance Companies, has been prepared on behalf of the accounting standards division by the AICPA Insurance Companies Committee and approved by the AICPA Accounting Standards Executive Committee. It proposes amendments to the AICPA industry audit guide, Audits of Fire and Casualty Insurance Companies.

The statement of position presents the division's recommendations on significant accounting issues related to property and liability insurance companies and amends those sections of chapter 9 of Audits of Fire and Casualty Insurance Companies that discuss the accounting practices followed in the industry.

Representatives of the division are available to discuss this proposed statement of position with you or your representatives at your convenience.

Sincerely,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

Accounting Standards Division

Accounting Standards Executive Committee

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Accounting for Property and Liability Insurance Companies

Introduction

1. The AICPA Insurance Companies Committee is in the process of revising the AICPA industry audit guide, *Audits of Fire and Casualty Insurance Companies* (referred to in this statement of position as the guide). The term *property and liability insurance companies* is the current terminology used to describe fire and casualty insurance companies and, therefore, is used throughout this statement of position. The committee has reviewed the section of the guide dealing with variances between (*a*) generally accepted accounting principles and (*b*) practices prescribed or permitted by insurance regulatory authorities and has identified areas in which existing practice varies, including areas in which further clarification of the guide seems necessary, and certain areas that were not discussed in the guide. This statement of position amends the guide to clarify and update those sections reviewed.

2. A discussion memorandum was issued in November, 1975, to obtain representative views on the appropriate accounting principles to be applied in the various areas under study from AICPA members, representatives of industry, and other interested parties. An exposure draft of a proposed statement of position was issued for comments on October 31, 1977. The responses to the discussion memorandum and exposure draft were considered in the preparation of this statement of position.

3. In recent years, accountants, investors, and other users of financial statements have expressed concern over the acceptability of accounting alternatives for similar business transactions. The accounting standards division believes that it is not desirable to have alternative accounting methods in the property and liability insurance industry. Therefore, this statement of position expresses the division's conclusions on accounting methods that should be used in the areas in which alternatives exist, except for the issues of (*a*) whether loss reserves should be discounted, which is discussed in paragraphs 34 through 41, and (*b*) whether anticipated investment income should be considered in computing premium

deficiencies, which is discussed in paragraphs 22 through 30. This statement of position does not apply to title insurance. The division's conclusions on accounting for title insurance are presently being considered by the AICPA's Insurance Companies Committee. Paragraphs 6 through 43 of this statement of position do not apply to mortgage guaranty insurance. The issues discussed in those paragraphs, as they relate to mortgage guaranty insurance, are also presently being considered by the insurance companies committee.

4. The division's conclusions set forth in this statement of position apply to financial statements of all property and liability insurance companies that are intended to present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Those companies include, but are not limited to, stock companies, mutual companies, and reciprocal exchanges or interinsurance exchanges.

5. The interests of policyholders and the public in the financial integrity of the property and liability insurance companies makes it important that the solvency of those companies be continuously demonstrated to regulatory authorities. Consideration of those interests, together with the uncertainties inherent in the future, has resulted in the conservative accounting practices prescribed or permitted by insurance regulatory authorities (statutory accounting practices).[1] Federal income taxation of property and liability insurance companies is also based primarily on statutory accounting practices. The use of generally accepted accounting principles, as discussed in this statement of position, should not be construed as an indication that those accounting principles should also be used in reporting to regulatory or taxing authorities.

Premium Revenue Recognition

Discussion

6. Premiums are generally collected as of the inception of the contract or installment period. Under statutory accounting practices, the premiums are recognized in income evenly over the con-

[1] Such practices have been prescribed by statute, regulation, or rule or have been permitted by specific approval or acceptance.

tract period, generally determined on a monthly or daily basis. That method, which was endorsed by the guide and has been generally accepted in the property and liability insurance industry, usually produces a proper association of premium revenue with losses and expenses that will be incurred over the contract period. However, some believe that a modification should be made to that basis of recognition if (*a*) the period of risk differs significantly from the contract period or (*b*) the incidence of risk, or the amount at risk, varies significantly during the contract period.

7. For the typical policy, the premium is fixed for the period of the contract. In most cases, the fixed amount is recognized over the contract period. However, for retrospectively rated and reporting-form policies, an estimated or deposit premium is collected which is adjusted at a subsequent date, based on experience. In some cases, the deposit premium serves as a means of financing and, therefore, may only be a portion of the estimated premium. Under statutory accounting practices, those premiums are usually accounted for in the following manner: (*a*) the original estimated or deposit premium is recognized evenly over the contract period with subsequent adjustments charged or credited to income as they occur, or (*b*) the ultimate premium is estimated, revised during the contract period to reflect current experience, and recognized evenly over the contract period. The guide is silent on that subject and practice varies.

Conclusions

8. In the insurance industry, the service provided is coverage; therefore, revenue should be recognized as that coverage is provided. The incidence of *losses* is not relevant to the recognition of revenue but is relevant to the recognition of costs, which should be recognized as losses are incurred.

9. In most instances, premiums should be recognized as being earned evenly over the term of the insurance contract determined on a monthly or daily basis as the coverage is provided. In those few instances in which the period of risk varies significantly from the contract term, the premium should be recognized evenly over the period of risk. Also, in those few instances in which the amount of coverage declines according to a predetermined sched-

ule, the premium should be recognized in proportion to the amount of coverage.

10. Premium adjustments (for example, adjustments on retrospectively rated and reporting-form policies) should be accounted for on the accrual basis using an estimate of the ultimate premium. The estimated ultimate premium should be revised to reflect current experience. In those rare situations in which the ultimate premium cannot be reasonably estimated, the accrual basis should not be used.

Deferred Acquisition Costs

Discussion

11. The guide discusses the accounting for costs incurred in connection with writing insurance and obtaining insurance premiums. The guide indicates that statutory accounting practices, which require those costs to be charged to income as they are incurred, do not produce a proper association of costs and revenue. Therefore, the guide suggests that those costs be deferred and amortized over the contract period. That method has gained general acceptance in the industry.

12. The guide provides little guidance on the types of acquisition costs to be deferred. As a result, the guide has been subject to differing interpretations that have resulted in variations in practices. The principal interpretations of the guide are as follows:

a. Only those costs that vary directly with and are directly related to the production of business (new and renewal premiums written) should be deferred.
b. In addition to costs that vary directly, certain costs that vary indirectly and are directly related to the production of business should be deferred.
c. All costs related to the production of business should be deferred.

13. The guide describes only one method for estimating deferred acquisition costs referred to as "equity in unearned premiums." Some suggest that the method can distort net income if the relationship of costs incurred to premiums written varies signifi-

cantly from period to period. If deferred acquisition costs are estimated based on a percentage relationship of costs incurred to written premiums, they suggest that the percentage relationship once determined, except for any adjustment related to recoverability (that is, premium deficiency as that item is described in paragraphs 17 and 18), should continue to be applied to the applicable unearned premiums throughout the term of the policies. Furthermore, they suggest that acquisition costs should be amortized using more precise methods such as those used for amortizing unearned premiums in order to associate more properly those costs with premium revenue.

Conclusions

14. Costs that vary with and are directly related to the production of business (new and renewal premiums written during an accounting period) should be deferred and amortized to income as the related written premiums are earned. Certain expenses, such as commissions and premium taxes, vary directly with and are directly related to the production of new business and can be associated directly with specific revenue. Other expenses, such as salaries of certain employees involved in underwriting and policy issuance functions, inspection report fees, and fees paid to boards and bureaus, may vary indirectly with the production of business but are directly related to the premiums written during the period in which the costs are incurred. Those costs meet the criteria for deferral and association with the related premiums as they are earned. Certain other costs incurred during the period, such as depreciation, collection expenses and uncollectible accounts, professional fees, and general administrative expenses, do not vary directly with and are not directly related to the production of business and therefore should be expensed as incurred.

15. To apply those expense recognition principles, costs should be analyzed to determine whether they can be associated with revenue. Arbitrary percentage allocations of expense classifications do not meet those criteria and therefore should not be used.

16. Acquisition costs should be deferred and amortized using methods such as those used for amortizing unearned premiums in order to associate more properly those costs with premium revenue. The calculations should be made by reasonable group-

ings of business consistent with the company's manner of acquiring, servicing, and measuring the profitability of its insurance products. If deferred acquisition costs are calculated based on a percentage relationship of costs incurred to written premiums for a specified period of time, the percentage relationship and the time period used, once determined, should be applied to the applicable unearned premiums throughout the term of the policies, except for adjustments related to premium deficiencies.

Premium Deficiencies

Discussion

17. The guide states that ". . . since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term. . . ." In addition, the guide suggests that the premium should be adequate to recover any unamortized deferred acquisition costs. Paragraph 96 of FASB Statement no. 5 indicates that ". . . this Statement does not prohibit (and, in fact, requires) accrual of a *net* loss, that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated. . . ."

18. The guide does not use the term "premium deficiencies" (a term adopted by the division to describe the views of the FASB, which are set forth in paragraph 96 of FASB Statement no. 5). However, with respect to evaluating the recoverability of acquisition costs to be deferred, the guide suggests that consideration be given to (*a*) the anticipated loss ratio, (*b*) the anticipated loss expense ratio, and (*c*) the anticipated ratio of expenses subsequent to acquisition. It further suggests that the determination of those anticipated ratios requires an analysis of historical data plus knowledge of other factors, such as giving greater weight to the more recent loss experience and taking into account recent rate changes that would be reflected in the unearned premiums in the balance sheet.

19. *Determination of Premium Deficiencies.* Premium deficiencies are determinable (*a*) by individual lines of business,

(*b*) by reasonable groupings of business consistent with the company's manner of acquiring, servicing, and measuring profitability of its insurance products, or (*c*) in the aggregate.

20. *Anticipated Expenses Subsequent to Acquisition.* As stated above, the guide suggests that anticipated expenses subsequent to acquisition should be considered in evaluating the recoverability of acquisition costs to be deferred. However, the guide provides little guidance regarding what types of expenses subsequent to acquisition should be considered. The guide has been interpreted in various ways as follows:

a. Only anticipated losses, loss adjustment expenses, and unamortized deferred acquisition costs directly related to policies in force should be considered in determining premium deficiencies.
b. In addition to anticipated losses, loss adjustment expenses, and unamortized deferred acquisition costs, certain other underwriting expenses (maintenance expenses) should be considered, provided that those costs may be attributed to maintaining the policies in force.
c. Anticipated loss and loss adjustment expenses, together with all other underwriting expenses, should be considered in determining premium deficiencies.
d. Anticipated policy dividends should also be considered in the above tests.
e. Anticipated investment income should also be considered in the above tests.

21. *Anticipated Investment Income.* The guide states that ". . . since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term. . . ." Furthermore, the guide suggests that the premium should be adequate to recover any unamortized deferred acquisition costs. FASB Statement no. 5, paragraph 96, requires the accrual of a *net* loss that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated.

22. The guide is silent on whether investment income should be considered in the calculation of premium deficiencies; FASB Statement no. 5 does not give specific guidance for the calculation of premium deficiencies; current practice has been not to include investment income in the determination of premium deficiencies.

23. Some believe that the consideration of anticipated investment income in the computation of premium deficiencies is proper for the following reasons:

a. The concept of establishing premium deficiencies is founded on the generally accepted accounting principle of making provisions for foreseeable losses on contracts currently in force. That concept relates to losses on entire contracts and therefore should include all revenue and expenses relative to those contracts. An integral part of the revenue on insurance contracts is the investment income that will be earned on the funds generated by the collection of premiums in advance of the payment of losses and expenses on those contracts.

b. The concept of accruing for loss contracts, that is, premium deficiencies, differs from discounting of loss reserves in that the premium deficiency calculation relates to the estimation of future revenue and expenses relative to particular loss contracts, while the concept of discounting loss reserves relates to a currently established liability for losses incurred. Furthermore, the inclusion of investment income is a recognition of interest that will be earned on contract funds that have been collected, while the discounting of loss reserves recognizes the time value of money that relates to funds that may be in excess of the actual funds available for investment on particular loss contracts. Hence, the investment income in the premium deficiency calculation relates to actual funds available for investment, while the discounting concept imputes investment income on funds that may not necessarily have been generated by those particular contracts.

c. The incidence of recognition of investment income related to unprofitable contracts should be different from the incidence of recognition of investment income related to profitable contracts because of the nature of the contracts. The investment income on profitable contracts should be recognized as earned

following the generally accepted accounting principle of not anticipating gains. However, the investment income relative to loss contracts should be used in determining the "net" loss relative to those contracts in accordance with the generally accepted accounting principle of recognizing *net* losses on unprofitable contracts. As the concept of loss recognition pertains to a "net" loss, it is contemplated that the calculation should include accrual of all anticipated costs and all anticipated revenue relative to those contracts.

24. Others believe that anticipated investment income should be considered in the calculation of premium deficiencies for the above reasons, but that it would be inconsistent to recognize that investment income and not discount loss reserves. They believe that the recognition of the time value of money results in financial statements that are more in accord with economic reality but cannot support recognizing the effects of anticipated investment income only in the case of premium deficiencies (see paragraphs 34 through 38, "Recognition of the Time Value of Money"). They further believe that to do so would create an unnecessary difference in the application of the matching concept to profitable and unprofitable contracts. Furthermore, they point out that the methodology involved in using investment income in the computation of premium deficiencies is very similar to discounting loss reserves, and, if loss reserves were discounted, the question of using investment income in the computation of premium deficiences would be moot.

25. Some believe that anticipated investment income should not be considered in the calculation of premium deficiencies for the following reasons:

a. FASB Statement no. 5 defines a net loss, which the division describes as a premium deficiency, as "a loss in excess of deferred premiums." They believe that the term "deferred premiums" is intended to mean "unearned premiums" as commonly used in the insurance industry. In expanding on that view, the guide further indicates that a premium should also be adequate to recover deferred acquisition costs and expenses subsequent to acquisition. The losses and expenses referred to do not suggest that losses and expenses should be

estimated any differently for that purpose than for financial statement presentation. Thus, they believe the term needs no further clarification and indicates no intention on the part of the FASB to consider investment income as a source of revenue in determining a net loss.

b. Furthermore, they believe that including investment income in the computation of premium deficiencies is not otherwise supported by current generally accepted accounting principles applicable to the determination of asset values. In testing the recoverability of asset values, they believe it may be proper to consider income *directly attributable* to that asset during the recovery period. In those cases, the income considered can be identified as being directly related to the asset being evaluated. In this situation, the asset being tested for recoverability is a deferred charge, which does not and could not generate income. The investable funds generated by the related unearned premiums cannot be segregated and identified with specific contracts. Even if a segregation were possible, they suggest one might find that contracts that are evidencing possible future deficiency problems have already consumed more funds in paying losses to date than they generated in total.

26. *Financial Statement Presentation.* Some believe that, except in rare instances, future net losses cannot be estimated any more reasonably than catastrophes. Therefore, they believe that the provisions of the guide and FASB Statement no. 5 have little, if any, applicability in practice in this area. Others believe that, while future net losses may not be as reasonably estimable as liabilities for incurred losses, they can be estimated with sufficient reliability to determine whether there will be a net loss on the contract. Therefore, to comply with the guide and the requirements of FASB Statement no. 5, they suggest the following methods to provide for premium deficiencies:

a. A premium deficiency should first be recognized by writing off any unamortized deferred acquisition costs to the extent required. Should the premium deficiency be greater than the unamortized deferred acquisition costs, loss reserves should be provided for an additional deficiency. This method recognizes that an asset has been impaired and that the impairment

should be recognized before any additional liabilities are recorded.

b. *Additional loss reserves* should be provided for the full amount of the premium deficiency with no adjustment to deferred acquisition costs. This method is supported by the view that the original premium contemplated the acquisition costs and that the deficiency is caused by losses in excess of those anticipated at the time premiums were established.

c. Unearned premiums should be increased by the amount of a premium deficiency. This method is supported by the view that the premium deficiency cannot be attributed to either the acquisition costs or additional losses.

Conclusions

27. *Determination of Premium Deficiencies.* Premium deficiencies should be determined by reasonable groupings of business consistent with a company's manner of acquiring, servicing, and measuring the profitability of its insurance products.

28. *Anticipated Expenses Subsequent to Acquisition.* In those instances in which expected losses and loss adjustment expenses, maintenance expenses, policyholder dividends, and unamortized deferred acquisition costs exceed the related unearned premiums, a provision for the anticipated premium deficiency should be provided (in accordance with FASB Statement no. 5, paragraph 96).

29. Expected losses and loss adjustment expenses, expected policyholder dividends, and unamortized deferred acquisition costs should be considered in determining premium deficiencies. In addition, certain other underwriting expenses (maintenance expenses) should also be considered, provided those costs can be attributed to maintaining the policies in force.

30. *Anticipated Investment Income.* Although this statement of position discusses the issue of whether anticipated investment income should be considered in computing premium deficiencies, no conclusion has been reached. Because of the importance of that issue, the division believes that it should expose for public comment its conclusions on the issue in a separate statement of position. Until the issue is resolved, companies that consider

anticipated investment income in computing premium deficiencies should disclose that fact in their note on accounting policies together with the effects on the financial statements.

31. *Financial Statement Presentation.* A premium deficiency should first be recognized by writing off any unamortized deferred acquisition costs to the extent required. Should the premium deficiency be greater than the unamortized deferred acquisition costs, a separate liability should be provided for the excess deficiency. That method recognizes that an asset has been impaired and that the impairment should be recorded before any additional liabilities are recorded.

Losses

Discussion

32. *Basis of Recognition.* Under statutory accounting practices, losses are recognized as incurred. Estimated liabilities are established for losses that have been reported, and additional estimates are made for losses that have been incurred but have not yet been reported to the company. That accounting method was endorsed by the guide, has been generally accepted by industry, and is reaffirmed in FASB Statement no. 5. For losses that are historically settled over a period of years, the estimates generally include the effects of inflation and other social and economic factors on the ultimate dollar cost of settlement; the effects are generally measured using information based on historical and reasonably foreseeable events and trends.

33. *Salvage and Subrogation.* Regulatory authorities generally do not permit recognition of estimated amounts of salvage and subrogation recoverable on paid and unpaid losses. The guide is silent on that subject and practice varies.

34. *Recognition of the Time Value of Money.* Some regulatory authorities permit liabilities for losses to be determined based on the present value of future payments for those types of losses that are payable in fixed installments over a long period of time, such as certain workers' compensation and disability insurance claims. Discounting of loss reserves, or the recognition of the time value of money, for other types of claims not expected to be

settled in one year is generally not permitted. Under generally accepted accounting principles, losses are generally recorded following statutory accounting practices. The guide is silent on that subject and practice varies.

35. Those who believe that liabilities for losses and loss adjustment expenses should be stated at their present value suggest that investment income, excluding investment income attributable to stockholders' (members') equity, is an inextricable part of insurance operations, and present value concepts should be applied to all liabilities that are not expected to be settled in one year, provided that the period for settling the losses can be reasonably estimated. In support of that viewpoint, they cite the fact that at least fifteen states are now taking investment income into consideration in determining premium rates. They believe that further support comes from a review of the economic history of the insurance industry over the last fifty years in which investment income exceeded $29 billion (excluding investment gains of $5 billion), while underwriting losses aggregated slightly in excess of $2 billion over the same period. From that perspective, they believe it is undeniable that if the insurance industry had to depend solely on premium revenue to cover claim costs, acquisition costs, and underwriting expenses, it simply would not survive.

36. Some believe that all liabilities for losses and loss adjustment expenses not expected to be settled in one year should be stated at their present value. Those who support that view believe that—

a. Recognition of the time value of money results in financial statements that are more in accord with economic reality than is the case without discounting. The economic history of the insurance industry and the present environment demonstrate that investment income and underwriting results are interrelated.

b. Valuing loss reserves at their present value is consistent with the generally accepted accounting principle of matching related revenue and expenses. Premium revenue would be matched against the estimated present value of claims incurred, while investment income would be matched against

the interest added to the reserves. If losses are not discounted, premium revenue is matched against the estimated total amount to be paid on claims incurred, while investment income has no offset.

c. Anticipated investment income plays a significant role in determining premium rates. Premiums on lines of business in which losses are settled in a relatively short period of time are generally higher in relation to anticipated losses than premiums on lines of business in which a substantial portion of the losses are settled over a period of years.

d. Current insurance accounting principles are inconsistent, inasmuch as reserves on life, annuity, and disability policies issued by life insurance companies are discounted, while long-term reserves of property and liability insurance companies are not.

e. Although the use of present values involves estimates of the timing of future payments, the estimates would be based on historical experience modified for current trends. The use of discounted loss reserves should not imply greater precision than gross dollar reserves because all elements of the loss reserve (gross dollar value, salvage and subrogation recoverable, and payment pattern)are estimates.

37. Those who support discounting, or the recognition of the time value of money, believe that the issue is so significant to the determination of financial position, results of operations, and changes in financial position of property and liability insurance companies that financial statements will continue to be interpreted differently until the issue is resolved.

38. Others believe that present value concepts should be applied only to those types of losses that are payable in fixed installments over a long period of time, such as workers' compensation and other forms of disability insurance. Those who support this view believe that—

a. Those liabilities are contractual obligations to pay money on fixed or determinable dates as contemplated in APB Opinion 21, *Interest on Receivables and Payables*.

b. Present value concepts should be applied only to those types of losses because the application of present value concepts to

other types of losses involve estimates of both the amounts and the timing of payments, and there is too much subjectivity inherent in establishing estimates of losses that will not be paid until some undetermined future date to permit those losses to be stated at their present value. To do so would imply a greater degree of precision than is warranted.

Conclusions

39. *Basis of Recognition.* Under generally accepted accounting principles, losses should be recognized in the financial statements as incurred, including estimates for incurred but not reported losses. Provisions for unpaid losses should be based on the best estimate of the ultimate cost of settlement (including the effects of inflation and other social and economic factors), reduced by estimated salvage and subrogation recoveries, using past experience adjusted for current trends and any other factors that would modify past experience. Changes in loss estimates resulting from the continuous review process and differences between estimates and ultimate payments should be reflected in income of the period in which the estimates are changed.

40. *Salvage and Subrogation.* Estimated amounts of salvage and subrogation recoverable on paid and unpaid losses should be recorded as a reduction of unpaid losses with disclosure of the amounts deducted.[2]

41. *Recognition of the Time Value of Money.* Although this statement of position discusses the issue of whether loss reserves should be discounted, that is, whether the time value of money should be considered in determining loss reserves, no conclusion has been reached. Because of the importance of that issue, the division believes that it should expose for public comment its conclusions on the issue in a separate statement of position. Until the issue is resolved, companies that discount loss reserves or loss adjustment expenses[3] should disclose that fact in their note on accounting policies together with the effects on the financial statements.

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[2] The insurance companies committee has noted that this accounting practice appears to be uniform; accordingly, disclosure of the estimated amount of salvage and subrogation is considered adequate, rather than presenting the estimated amount as an asset.

[3] See paragraphs 42 and 43.

Loss Adjustment Expenses

Discussion

42. Statutory accounting practices require that all costs associated with the settlement of losses be accrued in the period that the related losses are incurred. Those costs include amounts paid for outside services and direct, indirect, and fixed internal costs associated with the settlement of claims. No exception to that practice was presented in the guide, and the practice has been accepted in industry.

Conclusions

43. All expenses expected to be incurred in connection with the settlement of unpaid losses should be accrued. Certain of those expenses, such as legal and adjusters' fees, can be associated directly with specific losses paid or in the process of settlement. Other of those expenses, such as the internal costs of the claims function, cannot be associated with specific losses but are related to losses paid or in the process of settlement.[4]

Reinsurance

Discussion

44. Under statutory accounting practices, amounts recoverable from reinsurers related to paid losses are classified as an asset, whereas amounts recoverable on unpaid losses and for ceded unearned premiums are offset against the related liability accounts. The guide is silent on that subject, and the practice is generally accepted in the industry. However, some believe that all amounts recoverable from reinsurers should be classified as assets, subject to appropriate valuation allowances, rather than as offsets to liability accounts on the basis that generally accepted accounting principles do not permit offsetting receivables and payables to unrelated parties.

45. Those who support the statutory accounting practice believe that reinsurance is inextricably linked to the basic policy transaction. For example, if the amount of commercial fire coverage required exceeds the retention limit of any one company,

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[4] See paragraph 41.

the several companies insuring the risk could either issue separate policies for their portion of the risk or one company could issue a single policy for the total coverage and reinsure the coverage in excess of its retention limit. In either case, the net financial statement result is the same and form should not prevail over substance.

46. Under statutory accounting practices, reinsurance premiums ceded are reported as a reduction of written and earned premiums. The guide is silent on that subject and the practice is generally accepted in the industry. Some believe the purchase of catastrophe insurance coverage by a company is not a true sharing of risk and, therefore, the premiums should be treated as operating expenses as opposed to a reduction in written and earned premiums. Those who support the statutory accounting practice believe, as stated above, that reinsurance is inextricably linked to the basic policy transaction and that a distinction cannot be made between a sharing of risk and the purchase of insurance.

Conclusions

47. Amounts recoverable from reinsurers that are related to paid losses and loss adjustment expenses, if applicable, should be classified in the financial statements as assets, subject to appropriate valuation allowances. Estimated amounts recoverable from reinsurers that are related to unpaid losses and loss adjustment expenses should be deducted from the unpaid losses and loss adjustment expenses with disclosure of the amounts deducted.[5] Ceded unearned premiums do not represent receivables; therefore, those amounts should be netted against the related unearned premiums. Receivables and payables from the same reinsurer, including funds withheld, should be offset. Reinsurance premiums ceded and reinsurance recoveries on losses may be netted against the respective earned premiums and incurred losses in the income statement.

48. Companies should disclose (*a*) the nature of their reinsurance activities, (*b*) reinsurance premiums assumed and ceded that are included in or deducted from earned premiums (disclo-

[5] The insurance companies committee has noted that this accounting practice appears to be uniform; accordingly, disclosure of the estimated amount of reinsurance is adequate, rather than presenting the estimated amount as an asset.

sure should also be made on a written premium basis if the difference is material), and (*c*) premiums and recoveries on catastrophe type reinsurance contracts deducted from premiums earned and losses incurred, respectively.

Policyholder Dividends and Contingent Commissions

Discussion

49. Under statutory accounting practices—

a. Policyholder dividends are generally recorded as liabilities when declared by the board of directors.

b. Contingent commissions are recognized in financial statements on either the accrual basis, a modified cash basis (that is, accrual for commissions on expired contracts), or the cash basis.

Conclusions

50. Generally accepted accounting principles require the use of accrual basis accounting; therefore—

a. Dividends should be accrued using best estimates of the amounts to be paid.

b. Contingent commissions receivable or payable should be accrued over the period during which the related profits are recognized.

Valuation of Investments and Recognition of Related Realized and Unrealized Gains or Losses

Discussion

51. Under statutory accounting practices, investments in common and preferred stocks are carried at market value, bonds are generally carried at amortized cost, mortgages are generally carried at unpaid principal, and real estate generally is carried at depreciated cost. Realized investment gains or losses are credited or charged to income. Changes in the carrying amount of investments representing unrealized appreciation or depreciation are charged or credited to stockholders' (members') equity.

52. The statutory method of accounting for investments is supported by the following reasoning—

a. Carrying bonds whose value has not been permanently impaired at amortized cost is appropriate since a company that has the ability and intent to hold the investments to maturity will be able to realize face amount. Market values that reflect periodic changes in prevailing interest rates are irrelevant in valuing bonds that are expected to be held to maturity.

b. Carrying common and preferred stocks at market is appropriate because a company has no assurance that it will receive more or less than the current market value.

c. Including realized investment gains and losses in net income is appropriate since it is based on the realization principle. Periodic fluctuations in market value are appropriately recognized in valuing equity investments but should not be included in net income because the fluctuations do not meet the realization principle.

53. The guide endorses the statutory basis for valuing investments. However, it suggests that realized and unrealized investment gains or losses should be combined in a separate financial statement. Those who support the separate statement approach believe that valuation of investments under the statutory method is appropriate for the reasons stated above. However, they advocate that changes in the value of investments, whether realized or unrealized, should be presented in a separate financial statement as one combined amount. They believe that the treatment is the most meaningful since the realization of a gain or loss has an offsetting effect on the related unrealized gain or loss. Because of the materiality of the amounts and the significant fluctuations that occur, realized and unrealized gains or losses should not be included in the determination of net income because they feel they would make net income meaningless.

54. Some believe that the results of realized gains and losses should be reported as an integral part of an insurance company's results of operations because an investor's appraisal of an insurance company's performance should include the results of realized gains and losses over a period of years.

55. FASB Statement no. 12, *Accounting for Certain Marketable Securities*, discusses the accounting treatment to be followed by specialized industries, such as property and liability insurance companies, with respect to investments in common and preferred stocks.

Conclusions

56. Bonds should be carried at amortized cost if the company has both the ability and intent to hold the bonds until maturity and there is no decline in the market value of the bond other than a temporary decline. In those rare instances in which a company is a trader in bonds and does not intend to hold the bonds until maturity, the bonds should be carried at market; temporary fluctuations in the market value of the bonds should be recognized as unrealized gains or losses.

57. Common and nonredeemable preferred stocks should be carried at market. Preferred stocks that by their terms must be redeemed by the issuing company should be carried at amortized cost if the company has both the ability and intention to hold the stocks until redemption and there is no decline in the market value of the stocks other than a temporary decline.

58. Mortgages should be accounted for at unpaid principal unless collectibility is uncertain. Real estate investments should be accounted for at depreciated cost unless there is an impairment in value. Amortization, depreciation, and other related charges or credits should be charged or credited to investment income. Charges and credits to valuation accounts should be included in realized gains and losses.

59. Realized gains and losses on all assets held for investment (including, but not limited to, stocks, bonds, mortgage loans, real estate, joint ventures, and subsidiaries held for investment) should be included in the statement of income, below operating income and net of applicable income taxes. Realized gains and losses on the sale of other assets, such as property used in the business and operating subsidiaries, should be included in the statement of income before applicable income taxes. Unrealized

investment gains and losses should be recognized in stockholders' (members') equity net of applicable income taxes.

60. If a decline in the value of an investment in a security below its cost or amortized cost is other than temporary, the investment should be written down to its net realizable value, which becomes the new cost basis. The amount of the write-down should be accounted for as a realized loss. A recovery from the new cost basis should be recognized only at the sale, maturity, or other disposition of the asset, as a realized gain.

61. Valuation accounts are not appropriate for bonds, common stocks, or preferred stocks.

Real Estate

Discussion

62. Under statutory accounting practices, real estate is classified as an investment regardless of its use. For real estate used in operations, rent is included in investment income and is charged to the operating departments. The guide is silent on that subject, and the statutory accounting practice has gained general acceptance in the industry.

Conclusions

63. Real estate should be classified either as an investment or as property used in the business, based on its predominant use. Depreciation and other real estate operating expenses should be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rent expense should not be attributed to real estate used in the business.

Accident and Health Insurance

Discussion

64. Accident and health insurance contracts are issued by both property and liability insurance companies and life insurance companies. Currently, those companies may account for their

accident and health insurance contracts differently depending on which audit guide the companies follow.

Conclusions

65. The accounting for accident and health insurance contracts should be the same irrespective of the company issuing the contracts. The applicable provisions of this statement of position should be applied to short-term accident and health insurance contracts. The provisions of the industry audit guide, *Audits of Stock Life Insurance Companies,* should be applied to long-term accident and health insurance contracts. Individual and group contracts that are noncancelable, collectively renewable, or guaranteed renewable should be considered long-term contracts. Contracts that are renewable at the option of the company (cancelable contracts) may also be considered long term if it can be demonstrated that they are likely to remain in force for a reasonable period of time, similar to guaranteed renewable contracts. All other contracts should be accounted for as short-term contracts.

Transition

66. The conclusions in this statement of position should be applied to financial statements of property and liability insurance companies issued for annual and interim periods beginning after December 31, 1978. Earlier application is encouraged. The conclusions in this statement of position should be applied retroactively, and financial statements presented for prior periods should be restated. The individual effects of changing to the accounting principles in this statement of position should be disclosed in the financial statements.

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