Accounting Concepts for the Actuary

By Ralph S. Blanchard III, FCAS, MAAA

June 2003

CAS Study Note

Introduction

This article's purpose is to give an overview of accounting concepts and issues relevant to the actuary. To do this, it is divided into the following sections:

- Purpose of accounting
- Types of accounting
- Principal financial statements
- Sources of accounting rules
- Selected accounting concepts
- Common accounts for insurance companies

I. Purpose of Accounting

The purpose of accounting is generally ***not*** to provide the "answer" or "decision" for the user. It is to provide "information" to the user. The user is then free to perform their own analysis on this information, so as to arrive at their own economic decision based on the information.

Various accounting standard setters have developed criteria for such accounting information[1]. These criteria vary slightly by standard setting body, but generally include the concepts listed below.

Accounting information should be:

- Understandable
- Relevant
- Reliable
- Comparable and Consistent (across time, entities, industries)
- Unbiased
- Cost-benefit effective

Understandable

Accounting information should be readily understandable to the intended users of the information. Note that this is a function of both the intended users and the intended uses of the information. Accounting systems that define either the users or uses narrowly may justify more complex information requirements and standards. Accounting systems that envision a broad body of users and/or uses would tend towards less complexity in published information and standards.

[1] For the International Accounting Standards Board (IASB), such criteria are listed in the Framework for the Preparation and Presentation of Financial Statements (the IASB Framework). In the United States, the underlying criteria are found in the Financial Accounting Standards Board (FASB) Statements of Financial Accounting Concepts (SFAC).

There is typically the belief that, for information to be understandable, information contained in the various financial disclosures and reportings must be **transparent** (i.e., clearly disclosed and readily discernable).

Relevant

The information should be relevant to the decision-making users of the information. It should "make a difference" in their decisions. Typically, this means the information must be:

- Timely
- Have predictive value
- Provide useful feedback on past decisions

Reliable

The information should be reliable and dependable. This usually includes the concepts of:

- Representational faithfulness - the information represents what it claims to represent. For example, if the information is supposed to represent the total amount of ultimate claim payout expected, it should be that ultimate amount and not an implicitly discounted amount. If the reported value of a common stock holding purports to be the current market value, that value should be approximately what the stock could be sold for by the company holding it.
- Verifiability – another person or entity should be able to recreate the reported value using the same information that the reporting entity had.
- Completeness – the reported information should not be missing a material fact or consideration that would make the reported information misleading.

The concept of neutrality is sometimes incorporated into the concept of reliability. This article lists neutrality, or lack of bias, separately.

Comparable and Consistent

For accounting information to be usable, it must allow for comparisons across time and across competing interests (such as competing companies or industries). This leads to a need for some consistency, wherever such comparisons are to be expected. For example, comparisons of two companies would be very difficult and potentially misleading if one discounts all its liabilities while the other discounts none of its liabilities.

Unbiased

Information that is biased can be misleading. Biased information is not useful unless the users understand the bias, any bias is consistently applied across years/firms/industries, and the users can adjust the reported results to reflect their own desired bias. The option for an accounting paradigm, when faced with uncertainty, is to either requiring reporting of unbiased values accompanied with sufficient disclosure, or require the reporting of biased ("prudent" or "conservative") values with the bias determined in a predictable, consistent fashion.

Cost-Benefit effective

There is a general understanding that the development of accounting information consumes resources. As such, the cost of producing such information should be reasonable in relation to the expected benefit. This is reflected in many cases through the use of materiality considerations in accounting paradigms, such that accounting rules may not have to be fully followed for immaterial items if full compliance would result in unwarranted higher costs.

Relevance versus reliability

There is a natural tradeoff in many cases between relevance and reliability. For example, the value of an infrequently traded asset may be very relevant, if the clear intent is to eventually sell that asset to meet a liability. But the valuation of such an asset may be difficult or impossible to reliably determine. Different parties may place materially different values on that asset, such that the reported value is impossible to verify by an external party or auditor. The only reliable value for the asset may be its original cost, but such a value might not be relevant to the user of the information. Therefore the choice may be between a very relevant but unreliable value, or a very reliable but irrelevant value.

This issue also comes up with the valuation of difficult to estimate insurance liabilities. While a value may be estimable by an actuary, how reliable is that estimate? Can the user depend on that value, or could the user instead be materially misled by relying on that value? If a range of estimates could be produced, but only the low end of the possible valuation range could be reliably determined, booking the low end of the range may produce a reliable estimate but how relevant would it be? Would more disclosure be required to make the information complete – i.e., not misleading or lacking material facts?

Situations with uncertainty

As mentioned earlier, a conflict can arise between neutrality and reliability where uncertainty exists. Some accounting paradigms require conservatism or prudence in such circumstances. The rationale for requiring conservatism in the face of uncertainty is that an uncertain asset, or asset of uncertain value, cannot be relied upon. This may lead to the delayed recognition of some assets until their value is more dependably known or the ability to realize a gain from their sale is more certain (i.e., the value of the asset is "reasonably certain"). Relative to liabilities, this would lead to reporting of a high liability value, such that a final settlement value greater than the reported value is unlikely.

The danger with such approaches is in the reliability and consistency of their application. Given that uses of information can differ, what is conservatism to one user may be optimism to another. For example, a buyer of an asset would apply conservatism by choosing a high estimate while the seller would apply conservatism by choosing a low estimate[2]. Also, different users have different risk tolerances. Hence, any bias in accounting information runs the risk of producing misleading information, unless the bias can be quantified or adjusted for by the end user. As a result, accounting paradigms may opt instead for report-

[2] As another example, a high estimate of ultimate losses would be conservative when estimating claim liabilities but optimistic when estimating agents' contingent commissions.

ing of unbiased estimates when faced with uncertainty, accompanied by disclosure of the uncertainty, rather than requiring the reporting of biased estimates.

II. Types of Accounting

The previous section discussed what is necessary for accounting information to be useful to its users. But there are different kinds of users with different needs and levels of sophistication. Therefore, different users may need different accounting rules to meet their needs.

There are different ways users can be grouped, each of which could lead to a different set of accounting rules. In general, however, the grouping or potential grouping for insurance company purposes usually includes the following categories[3]:

- Investors, creditors – current and potential
- Regulators/Supervisors[4]
- Tax authorities
- Management

Accounting rules designed for a broad range of users (including investors, creditors and owners) are usually called general purpose accounting rules. These rules are also typically given the label Generally Accepted Accounting Principles, or GAAP.

The focus of GAAP accounting is typically on the value or performance of an organization as a going concern. This is an important point, as many liabilities or assets would have a significantly different value for a going-concern than they would for an entity in runoff. For example, the value of a tangible asset (such as large machinery or computer equipment) used by a going concern in its business may be the asset's replacement value, but the value for a company in runoff that no longer needs the asset may be the asset's liquidation market value. GAAP in this instance would be more interested in the replacement value (or depreciated cost) than the liquidation value.

Regulators interested in solvency regulation, however, may have more interest in runoff values than going concern values. This may lead them to develop their own specialized accounting paradigm, such as the "statutory" accounting rules produced by the National Association of Insurance Commissioners (NAIC) in the United States. Such rules may place more emphasis on realizable values for asset sale and liability settlement. Hence they may require a different set of valuation assumptions (possibly including mandatory conservatism or bias), resulting in accounting values materially different from GAAP values.

Tax authorities may also desire, demand, or be legally required to use their own specialized accounting paradigm. Such accounting rules may be directed or influenced by social engi-

[3] This category grouping for users was chosen due to its close alignment with common types of accounting. It leaves out the "rating agency" and "policyholder" user categories. These other users' interests are typically aligned with regulators/supervisors due to the focus on solvency concerns.
[4] The term "regulator" is common in the U.S., while the term "supervisor" is common in Europe.

neering, public policy, political, or verifiability concerns. As such they may be materially different from either GAAP or "statutory" accounting rules.

In the U.S., the tax accounting rules for insurance companies are based on statutory accounting, with modification. In many parts of the world, the GAAP, regulatory and tax accounting rules are the same. One advantage to having one set of accounting rules is reduced cost and confusion in the creation of the information. One disadvantage is that the needs of all the users are not the same, hence compromises must be made that are suboptimal to one or more sets of users. For example, a public policy issue that drives decisions of tax or regulatory authorities may result in accounting rules that produce misleading information for investors.

The general and two specialized accounting paradigms mentioned above may still not meet the needs of company management. As a result, many organizations create one or more additional sets of accounting paradigms with which to base their management decisions. These are generally based on either GAAP or regulatory accounting rules, with modifications.

For example, the treatment of large claims may require special treatment in evaluating individual branches of a company. While a constant volume of large claims may be expected for the total results of a company, their incidence may severely distort the evaluation of the individual business units that suffer the large claims in the single year being analyzed. If each business unit were a separate company, it might have limited its exposure to such a claim (for example, via reinsurance or coverage restrictions), but for the company as a whole it might make more sense to retain that exposure. Therefore, management may wish to cap any claims to a certain level, when looking at its internal "management accounting basis" results for individual business units, or may reflect a pro forma reinsurance pool among the business units in its internal accounting results.

As another example, the existing GAAP and/or regulatory accounting rules may not allow discounting of liabilities, possibly due to reliability concerns. Management, however, may feel that such discounting is necessary to properly evaluate the financial results of their business units, and within their operation they feel that any reliability concerns can be adequately controlled.

III. Principal Financial Reports

The principal statements in financial reports are the balance sheet, income statement and cash flow statement. These are usually accompanied by selected other schedules or exhibits, including various "notes and disclosures".

Balance Sheet

The balance sheet lists the assets and liabilities of the company, with the difference between the assets and liabilities being equity (sometimes referred to as "net assets", "capital" or "surplus"). This statement gives a snapshot of the current value of the company as of the statement or reporting date.

Note that some assets may not be required or allowed to be reported, due to concerns by the accounting standard setters with reliable valuation. Examples can include various types of "intangible" assets such as royalties, brand name or franchise value. Similarly, certain liabilities may not be reported due to reliability concerns. (See later discussion of "Recognition and Measurement", and the discussion in this section on "Notes and Disclosures".)

Income Statement

The income statement reports on the income and expenses of the firm during the reporting period, with the difference being net income or earnings. Income includes revenue and gains from sales, although it is not always necessary to distinguish between these two items.

Some accounting systems differentiate various types of income. For example, operating income is frequently defined to represent income from ongoing operations, excluding unusual one-time events or possibly realized capital gains whose realization timing is mostly a management decision. Other exclusions from operating income would be the effects of accounting changes, such as a change in how to account for taxes or assessments from governmental bodies.

In general, net income causes a change to equity, but may not be the sole source of changes to equity. An accounting system may have certain changes in value flow directly to equity, with no affect on income until they are realized. Examples sometimes include unrealized gains and losses on invested assets.

Cash Flow Statement

The cash flow statement reports on the sources and uses of cash during the reporting period, and should reconcile the beginning and ending cash position for the company.

Notes and Disclosures

The notes and disclosures sections of financial reports allow for additional information beyond the three statements mentioned above, including a description of the accounting policies used in preparing the financial statements and discussion of values that may not be reliably estimable. Such disclosures may include discussion of the risks and uncertainty associated with the insurance liability estimates found in the balance sheet and income statement (in some cases referred to as "management discussion and analysis"). They may also include "forward-looking information", concerning estimates of future financial earnings or events that have yet to occur by the financial report publication date. Note that these are different from "subsequent events" that may be disclosed, which are events that occurred after the statement or valuation date but before the publication date of the financial report.[5]

[5] For example, a catastrophe that occurred after the statement date but before the publication date would be a subsequent event, not included in the reported equity or income. In contrast, a discussion of future exposure to catastrophes for the coming year would be a "forward-looking" statement.

IV. Sources of Accounting Rules

Within any given accounting paradigm there are typically several different sources of rules. Where the rules for a given paradigm potentially conflict, a pre-defined hierarchy must be followed. Rules from a source higher on the hierarchy supercede or overrule those from a source lower on the hierarchy.

GAAP

The top of the GAAP hierarchy is generally the organization in charge of securities regulation for a particular jurisdiction. They may defer the rule setting to a specified accounting standard setter, such as the IASB, but they generally have the authority to add additional requirements or rules. They may also retain veto power over the designated accounting standard setter's proposed new rules[6]. A list of such organizations can be found on the web site of the International Organization of Securities Commissions (IOSCO).

Next in the hierarchy are the standards set by the specified accounting standard setter for that jurisdiction. The European Union has identified the International Financial Reporting Standards (IFRS) produced by the IASB as the accounting standards for companies with publicly traded securities. In the United States, the Securities and Exchange Commission (SEC) has designed the Financial Accounting Standards Board (FASB) as the accounting standard setter under the SEC. Note that these standards would be at the top of the hierarchy for companies that are not subject to public-traded securities rules (for example, a privately owned firm).

These standards may be supplemented by industry-specific guidance. In the United States, some industry-specific guidance in the form of Statements of Position (SOPs) came from a separate organization of accounting professionals called the American Institute of Certified Professional Accountants (AICPA). The U.S.'s FASB retained effective veto power over AICPA-issued guidance[7].

Last on the hierarchy would be interpretations, such as those issued by the IASB's International Financial Reporting Interpretations Committee. Interpretations are produced when timely guidance is needed, as they can be produced much faster than official accounting standards. This is due to the much shorter period for due process in the production of an official interpretation.

Regulatory/Supervisory Accounting

Regulatory accounting rules can consist of a totally separate set of standards, produced by or with the approval of the regulator, or can consist solely of additional specialized accounting schedules, filed in additional to the normal GAAP financial reports. Worldwide, it appears to be more common for the regulators to rely on GAAP financial statements. In

[6] This describes the situation in the U.S., where the SEC retains veto power over new FASB standards.
[7] The FASB decided in 2002 to eliminate this role for the AICPA in the future. Except for certain projects in process and not yet completed at that date, the FASB will no longer look to the AICIPA to create SOPs. (FASB newsletter The FASB Report, November 27, 2002.)

the U.S., regulators have developed a complete set of accounting rules, combining elements of both liquidation accounting and going concern accounting.

Tax Accounting (for Federal Income Tax purposes)

Tax accounting rules can be based on GAAP accounting rules, statutory accounting rules, or determined on a totally separate basis. This determination is generally based on tax law or regulation for the jurisdiction in question. Some countries rely on GAAP accounting reports to determine taxable income, while at least one relies on statutory accounting reports with modifications.

V. Selected Accounting Concepts

This section defines and discusses the following accounting concepts:

- Fair Value versus Historical Cost
- Recognition versus Measurement
- Deferral-Matching versus Asset-Liability
- Impairment
- Revenue Recognition
- Reporting Segment
- Liquidation versus Going Concern
- Change in Accounting Principle versus Change in Accounting Estimate
- Principle-based versus Rule-based

Fair Value versus Historical Cost

According to the IASB, "Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction."[8] It is meant to represent market value given a sufficiently robust and efficient market. Where no such market exists, the fair value conceptually would be estimated. When the fair value estimate is based on a model rather than an actually observed market value, it is called "marked to model" rather than "marked to market".

Historical cost is the amount (price) at which the asset or liability was originally obtained. Where the historical cost is expected to be different from the final value when the item is no longer on the balance sheet, some amortization or depreciation of the value may be called for. This can result in an amortized cost or depreciated cost value. These values are generally more reliably determinable, but less relevant than fair value.

Recognition versus Measurement

Accounting rules distinguish the decision or rule to recognize an asset or liability in financial reports from the rule establishing how to measure that liability once recognized. For example, the rule for when to record an asset may be to wait until the financial benefit from it is virtually certain, but the rule for measuring it at initial recognition may be to re-

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[8] From the IASB's Draft Statement of Principles for Insurance Contracts, paragraph 3.4, released November 2001.

cord its most likely value. Hence the probability standard for recognition may vary from the probability standard for measurement.

There may also be multiple recognition triggers and measurement rules. For example, the rule for initial recognition may differ from the rule for the triggering of subsequent remeasurement. The rule for initial recognition of an asset may be based on "reasonable certainty" of economic value. The measurement basis may then be its fair value, which implicitly includes a discounting of future cash flows. This initial measurement value would then be included in subsequent financial reports (i.e., "locked-in") until the remeasurement is triggered, ignoring the change in assumptions and facts since the original measurement. The rule for the triggering of subsequent remeasurement may be whether the undiscounted flows are likely to be less than the current value.

Deferral/matching versus asset/liability

Two major classes of accounting paradigms are deferral/matching and asset/liability.

Under a deferral/matching approach the focus is to coordinate the timing of income and expense recognition so that both occur at the same time, when the triggering event that is the focus of the contract occurs. For example, under a deferral/matching approach the premium is not recognized when received but is instead recognized ("earned") over the policy term during the period the insurance protection is provided. Likewise, the related expenses and incurred losses are not recognized when paid or committed to but are instead recognized over the same period as the premium. This may lead to the deferral of some up-front expenses, and the accrual of some losses that may take decades to pay. The deferral/matching approach requires the establishment of certain assets and liabilities to defer or accelerate recognition of revenue, expense or loss, in order to obtain the desired income statement effect[9]. Hence the focus is on the income statement more than the balance sheet.

Under an asset/liability approach, the focus is on the value of assets or liabilities that exist as of the balance sheet date. An asset is booked if a right to a future stream of cash flows (or to an item that could be converted to future cash flows) existed at the reporting date. Likewise, a liability is booked if the entity was committed to an obligation at the balance sheet date that would result in the payment of future cash flows or other assets. Such an approach would not recognize a "deferred acquisition cost" as an asset if it cannot be transferred or translated as cash. It would also not recognize an unearned premium liability beyond that needed for future losses, expenses or returned premiums associated with that contract. In general, the income statement is whatever falls out of the correct statement of the assets and liabilities, hence the focus on the balance sheet over the income statement.

Proponents of a deferral/matching approach have commonly focused on the timing of profit emergence. Absent changes in estimates, under a deferral/matching approach the profit emerges in a steady pattern over the insurance policy term.

[9] The two most common balance sheet accounts resulting from this approach for insurance companies are Deferred Acquisition Cost (DAC) assets, used to defer the impact of certain up-front expenses on the income statement, and Unearned Premium liabilities, used to defer the reflection of revenue.

Proponents of an asset/liability approach have commonly stressed the importance of reliable measures of value at the reporting date. They typically favor the booking of only those assets that have intrinsic value[10], and the immediate reflection of liabilities once they meet recognition criteria, rather than (what some consider) an arbitrary deferral to smooth out reported earnings.

It is possible for both approaches to produce comparable income statement results[11], and one would generally expect both to produce comparable equity values, but the actual data available to the user may vary significantly between the two approaches[12]. It is also possible for a single accounting paradigm to combine elements of both these approaches.[13]

Revenue Recognition

A key question in some accounting situations is when to recognize revenue. This is particularly important for those industries where revenue growth is a key performance measure.

Under a deferral/matching approach, revenue would be recognized only as service is rendered. In the insurance context, revenue would be recognized under the deferral/matching approach over the policy period in proportion to the covered insurance risk. Under an asset/liability approach, revenue would be recognized up front, once the insurer gained control of the asset resulting from the revenue. Therefore, the timing of revenue recognition is a function of the chosen accounting paradigm.

Impairment

It is possible to reflect one paradigm for income statement purposes and another for balance sheet purposes. This sometimes leads to the use of "impairment" tests and rules, to prevent inconsistencies between the two valuations from growing too large or problematic. (An asset may be considered impaired if it is no longer expected to produce the economic benefits expected when first acquired.)

For example, consider an accounting paradigm that requires an asset to be reported at its fair value with regular remeasurement for balance sheet purposes, but at locked-in historical cost valuation for income statement purposes. A risk under such an approach is that the two could become significantly out of sync, such as when the fair value of assets have dropped significantly below their historical cost. This risk can be alleviated through required regular testing of any such shortfall, to determine whether such a shortfall is permanent (i.e., whether a "permanent" impairment exists). When this happens, the extent of

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[10] In contrast to certain assets that can exist under a deferral/matching approach that have no intrinsic value, such as a deferred acquisition cost asset. For example, it is impossible to sell a deferred acquisition cost asset due to its lack of intrinsic value.

[11] For insurance contracts, a principal determinant of how similar the income statements would be under the two approaches is the treatment of risk when valuing assets and liabilities. For example, the asset or liability risk margin under an asset/liability approach could be set such that profit is recognized evenly over the coverage period. This could recreate the same profit emergence pattern found under a deferral/matching system.

[12] A deferral/matching paradigm is used by the IASB for accounting for service contracts, while the IASB endorsed in 2003 an asset/liability paradigm for insurance contracts.

[13] This is sometimes called a "mixed attribute" paradigm.

permanent impairment would be reflected in the income statement. The result would be a reduction in the discrepancy between the cumulative income statements and cumulative balance sheet changes, without bringing the income statement to a fair value basis.

Reporting Segment

GAAP financial statements are typically produced on a consolidated basis for the reporting entity. The consolidation may include the combined impact of multiple legal corporations or other entities with the same ultimate parent company or owner.

Regulatory financial statements may be required on a non-consolidated basis, separately for each legal entity, matching the legal authority of the regulator to intervene.

GAAP accounting rules also require reporting at the Reporting Segment level, generally defined as the level at which operations are managed and performance measured by senior management.[14] Reporting segments may be defined by product, by geography, by customer or other similar criteria, alone or in combination with other factors. The reporting segment selection is based on they way a particular company operates. For example, a company producing one product but in multiple regions, with somewhat autonomous management and functions by region, may be required to define its reporting segments by geographic region. A company with multiple products in one geographic market, with generally autonomous management by product unit, may define its reporting segments by product.

Where the accounting standard defines reporting segment requirements, it typically also includes a list of required items to be reported by reporting segment. Note that not all items are required to be reported by reporting segment. For example, income statements may have to be disclosed by reporting segment, but not balance sheets.

Liquidation versus Going Concern

Many GAAP paradigms focus on the assumption that the business is a "going concern" when valuing an asset or liability. This is in contrast with a runoff or liquidation assumption. For example, the value of a factory in use to produce a profitable product may be much greater than the value the factory could be sold for in a liquidation scenario. A runoff assumption may be more appropriate for regulatory accounting purposes, where a solvency focus exists.

Change in Accounting Principle versus Change in Accounting Estimate

Accounting paradigms may have drastically different reporting requirements for a change in accounting principle versus a change in accounting estimate. A change in accounting principle may require special disclosure of the change, with recalculation of prior period

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[14] The IASB standard in reporting segments, IAS 14, defines reporting segments as follows: "Segments are organisational units for which information is reported to the board of directors and CEO unless those organisational units are not along product/service or geographical lines, in which case use the next lower level of internal segmentation that reports product and geographical information." (quoted from a summary of IAS 14 found on the IASB website www.iasb.org.uk).

results[15], while a change in accounting estimate would generally involve no prior period recalculation and impact only the latest reporting period.

For example, a change from undiscounted liability estimates to present value estimates would typically be described as a change in accounting principle, possibly requiring recalculation of prior period results. A change in the estimated amount of undiscounted liabilities would be a change in accounting estimate, requiring no prior period recalculation and only impacting the reporting period where the estimate was changed[16].

Where the change in accounting principle is due to a change in accounting standard, the new standard itself will usually provide the preparer with specific implementation guidance.

Principle-based versus Rule-based

Accounting standards may take the form of general principles, relying on interpretation and judgment by the financial statement preparers before they can be implemented. Alternatively, standards may take the form of a series of rules, limiting the flexibility and use of judgment allowed in their implementation. This is a natural tradeoff, with advantages and disadvantages to each approach.

Principle-based standards are potentially very flexible with regard to new and changing products and environments. As such, they should also require less maintenance. But they do have certain disadvantages, such as being more difficult to audit relative to compliance, and concern over consistent and reliable interpretations across entities. To the extent that they rely on individual judgment to interpret and implement the standards, there is a danger that they can be used to manipulate financial results.

Rule-based standards are generally considered easier to audit for compliance purposes, and may produce more consistent and comparable financial reports across entities. Disadvantages may include a lack of flexibility with regard to changing conditions and new products, hence requiring almost continual maintenance at times. A concern also exists that rule-based standards are frequently easier to "game", as entities may search for loopholes that meet the literal wording of the standard but violate the intent of the standard.

VI. Common Accounts for Insurance Companies

The following are some common accounts used by insurance companies in conjunction with insurance contracts sold. Note that this list excludes accounts that are not directly insurance related, such as those for invested assets.

[15] When recalculation is required it would generally impact only the results for prior periods required to be shown in the financial statement at the time the accounting principle is changed. A cumulative effective adjustment may also be required for the oldest period shown, equaling the adjustment required to bring the beginning balances in compliance with the new accounting principle being implemented.
[16] Additional disclosure may be required when the change in estimate is material to the interpretation of the financial reports.

Balance Sheet Accounts - Assets

Premiums Receivable (or Premium Balances or Agents Balances or something similar) – premiums due on policies, either from agents if the agent bills the policyholder or from the policyholder if billed directly.

Reinsurance recoverables – amounts due from reinsurers due to ceded losses. In some accounting paradigms, the amounts billed and due as a result of ceded paid losses are recorded as an asset (and sometimes called reinsurance receivables), while the amounts to be ceded and billed in the future as a result of incurred but unpaid losses are recorded as a contra-liability (and called reinsurance recoverables).

Deferred acquisition costs – expense payments that are deferred for income statement purposes under a deferral-matching accounting paradigm. They are deferred so that they can be recognized in the income statement at the same time as the corresponding revenue.

Balance Sheet Accounts - Liabilities

Policy liabilities (or Provision for Unexpired Policies or something similar) – a liability established for in-force insurance policies for future events, for which a liability exists due to a contract being established. There is no policy liability for policies that have yet to be written, however a policy liability may exist for events covered by the renewal of existing policies, under certain situations. For example, a policy liability would exist for level premium renewable term life insurance, but not for possible renewals of property insurance contracts where the pricing is not guaranteed and either party can decide to non-renew.

Unearned Premium Liability – a liability caused by the deferral of premium revenue under a deferral-matching accounting paradigm. The amount of unearned premium liability generally represents the portion of policy premium for the unexpired portion of the policy. In an asset/liability paradigm this would be replaced by a policy reserve.

Claim liabilities – a liability for claims on policies for events that have already occurred. This would typically include amounts for both reported claims and for Incurred But Not Reported (IBNR) claims. It would also include amounts for Incurred But Not Enough Reported (IBNER), sometimes called supplemental or bulk reserves, for when the sum of individual claim estimates for reported claims are estimated to be too low in the aggregate. In some cases, IBNR is used to refer both of the last two amounts.

Claim expense liabilities – the liability for the cost of settling or defending claims on policies for events that have already occurred. This includes the cost of defending the policyholder (for liability policies). It can also include the cost of disputing coverage with the policyholder. It sometimes is included in the Claim liability value discussed above.

Insurance expense liabilities – the liability for expenses incurred but unpaid in conjunction with the insurance policy, other than the claim expenses discussed above. Typical subcategories include commission liabilities (sometimes split into regular and contingent commission liabilities) and premium tax liabilities (where applicable).

Income statement accounts

Premiums – in an asset-liability paradigm, this may equal written premiums, while in a deferral-matching premium, this would equal earned premiums. Earned premiums equal the written premiums less the change in unearned premium liabilities. They represent the portion of the charged premium for coverage under the reporting period.

Losses – Claims incurred during the reporting period. They represent the amount paid for claims plus the change in claim liabilities.

Loss expenses – Claim expenses incurred on claims resulting from events during the reporting period. Note that a claim expense can be incurred on a non-covered claim due to the necessary cost to dispute non-covered filed claims. These amounts are sometimes included in Losses.

Underwriting expenses – Expenses incurred that directly relate to the insurance operation. They include commission expenses, other acquisition expenses, general expenses and overhead related to the insurance operation, and various fees and taxes related to the insurance operation.

Underwriting income – Premium revenue less losses, loss expenses and underwriting expenses.

Policyholder dividends – Dividends to policyholders incurred during the reporting period. In some accounting paradigms these amounts are legally incurred only when declared. In others, an estimate of historical dividends relating to the policy coverage provided during the reporting period must be made and allocated to that reporting period. These amounts are generally included in underwriting income, but may not be for some purposes. It is possible for them to be subtracted from revenue under some accounting paradigms.

Discounting treatment

There are several ways discounting can be handled by an accounting paradigm. When discounting a liability, the amount of the discount could be treated as an asset with the liability reported on an undiscounted basis. Alternatively, the liability could be established on a discounted basis directly. Other options may exist, such as including the discount as a contra-liability in a separate liability account.

The establishment of any present value estimates will require the reporting of the unwinding of discount over time, somewhere in the income statement. One approach for an accounting paradigm is to report the unwinding as an interest expense. Another approach is to report the unwinding as a change in liability estimate, perhaps with separate disclosure so it can be distinguished from other sources of changes in estimates.

Resources:

- CAS Task Force on Fair Value Liabilities - White Paper on Fair Valuing Property/Casualty Insurance Liabilities (fall 2000)
- IASB Draft Statement of Principles (DSOP) on Insurance (fall 2001)
- International Accounting Standards: Framework for the Preparation and Presentation of Financial Statements (1989)
- Introduction to Accounting, second edition (1991), published by the American Institute for Property and Liability Underwriters (on the CPCU 8^{th} exam at that time).
- FASB website, at www.fasb.org
- IASB website, at www.iasb.org.uk

Also recommended is the following paper, discussing the work on developing a new IASB insurance accounting standard up to the paper's publication date in 2003: "The Search for an International Accounting Standard for Insurance: Report to the Accountancy Task Force of the Geneva Association," by Gerry Dickinson.

The author of this article would like to thank the following people for numerous helpful comments as the article was drafted: Keith Bell, Sam Gutterman, and Gary Venter.