



**Federal Accounting Standards Advisory Board**

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October 10, 2014

**Memorandum**

To: Members of the Board

*Robin M. Gilliam*

From: Robin M. Gilliam, Assistant Director

Through: *Wendy M. Payne*, Executive Director

Subject: Risk Assumed—Insurance Phase – **Tab H**<sup>1</sup>

**MEETING OBJECTIVES:**

- I. To review and approve disclosures for borrowing authority, borrowing, and interest expense.
- II. To determine if SFFAS 7, paragraphs 36-37 are sufficient guidance for unearned revenue.
- III. To determine whether to include claim adjustment expenses in insurance program liabilities.
- IV. To review and consider the need for guidance regarding recognition of a liability for premium deficiency.
- V. To review and approve the wording of proposed standards documenting decisions at the August 2014 meeting.

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<sup>1</sup> The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

## **BRIEFING MATERIALS**

Staff Memo

Attachments:

- Attachment 1: First draft of the Exposure Draft (ED). The following sections are omitted: executive summary, questions for respondents, introduction, financial report of US disclosures, basis for conclusion, and illustrations.
- Attachment 2: Borrowing disclosures for insurance and non insurance programs

Appendices: (Optional Reading for Reference):

- Appendix A: Risk Assumed - Project Decision History and Milestones
- Appendix B: List to date of Identified Insurance/ Programs
- Appendix C: List to Date of Programs Named as “Insurance” But not Identified as Insurance Programs
- Appendix D: AICPA Accounting and Auditing Guide—Property and Life Insurance

## BACKGROUND

During the August 2014 meeting, the Board approved the definition, criteria, and exclusions with the following adjustments:

- Removed “other than a defaulted debt obligation” reference from the definition and adverse event criteria, and kept it only in the exclusions.
- Removed the term, “non-loan guarantees,” and added a foot note that states— Insurance programs will also include guarantee programs not designed for loan/debt guarantees
- Changed the first exclusion to read “Loan guarantee programs as defined in SFFAS 2...,” to include all programs captured in SFFAS 2.
- Removed reference to the Stafford Act in the exclusion section, for consistency with other standards, and added discretionary funding as one type of assistance provided by disaster relief programs.
- Added federal self-insurance programs as an exclusion.

The Board agreed that the following were not clear and needed to be defined for consistent reporting:

- Reserve for premium deficiency
- Borrowing
  - the Board requested staff to define borrowing as it applies to insurance programs and to provide examples of borrowing disclosures from insurance and non insurance programs Investments and interest income

The Board decided to disclose the following items and events (including new laws and/or changes in actuarial assumptions) that caused material changes for: exchange revenue, recoveries from acquired assets, investments and interest income, appropriations used, and funds transferred out to Treasury.

In relation to risk assumed the Board was not interested in future projections for insurance programs.

- They agreed that insurance in force would meet the objective for providing the risk assumed by the insurance programs.
- The Board did agreed that the issue for forward projections would remain open, because they might want to address it for other types of programs in future phases of the risk assumed project.

I. **Review and approve how to disclose borrowing, borrowing authority, and interest expense :**

**Staff Recommendation:**

Current borrowing disclosures<sup>2</sup> by insurance and non insurance programs are concise and descriptive in accordance with SFFAS 1, *Accounting for Selected Assets and Liabilities*, SFFAS 5, *Accounting for Liabilities of The Federal Government*, and SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*. They disclose at the end of the reporting period:

- Borrowing balances (agency debt to Treasury)
- Available borrowing authority
- Repayment requirements, financing sources for repayment, and other terms of borrowing authority used
- Interest expense on borrowing
- An explanation for event(s) that caused material changes.

Staff recommends that insurance programs continue disclosing borrowing authority, outstanding debt (borrowing), and interest expense in accordance with SFFAS 1, SFFAS 5, and SFFAS 7 but provide a reference to the appropriate notes with the insurance disclosures.

**Staff Analysis:**

Borrowing authority is budget authority provided by Federal law to incur financial obligations that will result in immediate or future outlays but requires funds to be borrowed to liquidate the obligation.<sup>3</sup>

The difference between borrowing by non insurance and insurance programs is generally in the timing and request for borrowing. Borrowing for non insurance programs appears to be proactive; borrowing for insurance programs appears to be reactive.

Most non insurance programs have loan agreements with the Federal Financing Bank (FFB)<sup>4</sup> to receive borrowing before providing loans to citizens, such as student, housing, or small business loans. These loans are repaid from the loan repayments made by students, homeowners, or small business owners.

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<sup>2</sup> See Attachment 2 – Borrowing Disclosures for examples.

<sup>3</sup> Paraphrased from the FASAB Glossary, Appendix E, page 10

<sup>4</sup> FFB is a government corporation under the general supervision and direction of the Secretary of the Treasury, FY 2013/2012 Financial Statements, page 1: <http://www.treasury.gov/ffb/>

Insurance programs borrow money from the Department of Treasury, Fiscal Service (Bureau of Public Debt), because their exchange revenue will not cover losses.

See Attachment 2 for examples of borrowing disclosures for insurance and non insurance programs.

## CURRENT CONCEPTS & STANDARDS RELEVANT TO BORROWING

### **SFFAS 1: *Accounting for Selected Assets and Liabilities***

#### Borrowing Related to Interest Payable

81. Interest payable should be recorded for the amount of interest expense incurred and unpaid. Interest incurred results from **borrowing** funds from Treasury, Federal Financing Bank, other federal entities, or the public. Interest also should be recorded on late payment of bills by the federal entity (see provisions in 31 U.S.C. 3901 through 3907, Prompt Payment) and on refunds (see provisions in 26 U.S.C. 6611). Interest payable of an entity on borrowed funds and unpaid bills should be recognized at the end of each period.

#### Borrowing Related to Fund Balance with Treasury

106. The recommended standard provides guidance on the composition of fund balance with Treasury. Events that cause an entity's fund balance to increase include receiving appropriations, allocations, transfers, receipts that the entity is authorized to spend (or to use to offset its expenditures) and **borrowing** from Treasury. An entity's fund balance is reduced by amounts disbursed to pay liabilities and expenditures, amounts invested in securities, amounts of appropriations canceled or rescinded, and amounts transferred to other agencies or to the Treasury.

112. **Authority to borrow** does not in itself place funds into an entity's accounts with Treasury. In order to increase its fund balance with Treasury, an entity must actually **borrow** under its borrowing authority.

### **SFFAS 5: *Accounting for Liabilities of The Federal Government***

#### Federal Debt and Related Interest Cost

47. This standard applies to all securities or other debt instruments issued by the U.S. Treasury or other federal agencies. It encompasses debt issued to the public and **debt issued to federal accounts by other federal accounts**.

48. Accounting for the federal debt should identify the amount of the **outstanding debt liability of the federal government at any given time and the related interest cost for each accounting period. ...**

**SFFAS 5: Appendix B: Liability Recognition and Measurement Matrix**

<b>Federal Program Category</b>	<b>Expense</b>	<b>Liability</b>
Federal debt <ul style="list-style-type: none"> <li>• Treasury debt to federal agencies</li> <li>• <b>Federal agency debt to the Treasury</b></li> <li>• Federal debt to the public</li> </ul>	Recognize accrued (prorated) share of the nominal interest incurred during the accounting period, amortized discount or premium, and the amount of any change in current value for the accounting period for variable-value securities.	Recognize a liability at the par value of the security net of any unamortized discount or premium.

**SFFAS 7 – Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting**

Disclosures, Supplementary Information, and Other Information

14. Disclosures are required about the use of borrowing authority and the status of budgetary resources that may affect future spending by the entity.

24. Budgetary resources have a different character than both exchange revenue and nonexchange revenue. ... Appropriations are recognized as capital when enacted into law, while **borrowing authority is disclosed in notes.**

79. The following information about the **status of budgetary resources should be disclosed.**

- (b) available borrowing ...at the end of the period;
- (c) repayment requirements, financing sources for repayment, and other terms of borrowing authority used...

**Question I: Does the board approve requiring a reference to the disclosure for borrowing authority, borrowing, and interest expense from the insurance notes?**

**II. Determine if SFFAS 7, paragraphs 36- 37 are sufficient guidance for unearned revenue.**

**Staff Recommendation:**

Staff recommends that earned and unearned premiums be recognized for insurance programs consistent with current SFFAS 7 guidance for exchange revenue.

Staff requests that the Board review the current reference to revenue recognition and unearned revenue in SFFAS 7, paragraph 36-37, to determine if it provides enough guidance to reference to it from the proposed insurance standards.

**Staff Analysis:**

SFFAS 7, paragraphs 36-37, reads:

36. Revenue from specific types of exchange transactions should be recognized as follows:

(a) When services are provided to the public or another Government entity (except for specific services produced to order under a contract), revenue should be recognized when the services are performed.

(b) When specific goods are made to order under a contract (either short- or long-term), or specific services are produced to order under a contract (either short- or long-term), revenue should be recognized in proportion to estimated total cost when goods and services are acquired to fulfill the contract. If a loss is probable (more likely than not), revenue should continue to be recognized in proportion to the estimated total cost and costs should continue to be recognized when goods and services are acquired to fulfill the contract. Thus, the loss should be recognized in proportion to total cost over the life of the contract.

(c) When goods are kept in inventory so that they are available to customers when ordered, revenue should be recognized when the goods are delivered to the customer.

(d) When services are rendered continuously over time or the right to use an asset extends continuously over time, such as the use of borrowed money or the rental of space in a building, the revenue should be recognized in proportion to the passage of time or the use of the asset. The interest received on money borrowed in an intragovernmental transaction is an exchange revenue when the source of the borrowed funds is predominantly exchange revenue and is a nonexchange revenue when the source of the borrowed funds is predominantly nonexchange revenue or other financing sources.

(e) When an asset other than inventory is sold, any gain (or loss) should be recognized when the asset is delivered to the purchaser.

37. When advance fees or payments are received, such as for large-scale, long-term projects, revenue should not be recognized until costs are incurred from providing the goods and services (regardless of whether the fee or payment is refundable). An increase in cash and an increase in liabilities, such as “unearned revenue,” should be recorded when the cash is received. “Unearned revenue” should also be recorded if an agency requests advances or progress payments prior to the receipt of cash and records the amount.

**Question II: Does SFFAS 7, paragraphs 36-37 provide enough guidance to allow a reference from the insurance standards for unearned revenue?**

### **III. Determine whether to include claim adjustment expenses in insurance program liabilities**

#### **Staff Recommendation:**

Staff recommends that the proposed standards for insurance programs require the recognition and disclosure of claim adjustment expenses which are defined as: expenses incurred in the course of investigating and settling claims. Claim adjustment expenses include any direct expenses incurred such as legal and adjusters' fees, and the costs of paying claims and all related expenses.

#### **Staff Analysis:**

**FASB ASC 944-40-25** states that both of the following shall be accrued when insured events occur:

- a. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer)
- b. A liability for claim adjustment expenses; that is FAS 060, paragraph 9a liability for all costs expected to be incurred in connection with the settlement of unpaid claims.

SFFAS 5 requires the recognition of unpaid claims incurred, reported and not reported, however it is unclear as to what expenses are included to settle claims.

104. All federal insurance and guarantee programs (except social insurance and loan guarantee programs) should recognize a liability for unpaid claims incurred, resulting from insured events that have occurred as of the reporting date... Insurance and guarantee programs should recognize as an expense all claims incurred during the period, including, when appropriate, those not yet reported and contingencies that meet the criteria for recognition.

The FASB standards require recognition of all costs expected to be incurred to settle a claim—the claim itself and the related claim adjustment expenses; those expenses without which the claim could not be settled. This is consistent with the definition of “settlement amount” in SFFAC 7, *Measurement of the Elements of Accrual-Basis Financial Statements in Periods After Initial Recording*, paragraph 43--Settlement amount is the amount at which an asset can be realized or a liability can be liquidated.

Note also that SFFAS 2, *Direct Loans and Loan Guarantees*, and the Credit Reform Act that it was modeled after, exclude the administrative costs to settle direct loans and loan guarantees from the calculation of subsidy rates and loan guarantee liabilities.

**Questions III: Does the Board approve including claim adjustment expenses in insurance program liabilities?**

**IV. To review and consider the need for guidance regarding recognition of a liability for premium deficiency.**

**Staff Recommendation:**

A Premium Deficiency Reserve, according to insurance industry standards, is to recognize that the unearned premiums are not enough to cover the expected losses.

While federal agencies are not tasked with making a profit, users need to understand whether premiums are sufficient to cover expected losses. When premiums do not cover expected losses, federal insurance programs will have to use existing budgetary resources (appropriations or borrowing authority) or request additional resources to subsidize the losses. Reporting on the premium deficiency would help users understand the operating performance of the program as well as their need for additional budgetary resources including borrowing authority.

Staff recommends (1) separating the liability now required by SFFAS 5 into two components—liability for unpaid claims and liability for premium deficiency, and (2) more clearly addressing recognition of contingent liabilities by expanding federal GAAP for federal insurance programs.

1. This would require expanding federal GAAP for federal insurance programs to potentially include guidance for: Defining a liability for premium deficiency in addition to the liability for unpaid insurance losses
2. Developing measurement guidance regarding:
  - a. The unit of analysis (that is, what blocks or groups of insurance programs should be used to test for premium deficiencies)
  - b. The projection period (for example, the life of current agreements in the block of insurance programs and/or any additional period during which renewal is guaranteed at specified rates)
  - c. The flows to be included in the analysis:
    - i. Expected future benefits (including guidance regarding treatment of subsequent events)
    - ii. Unearned premiums
    - iii. Expected claim adjustment expenses which include any direct expenses incurred such as legal and adjusters' fees, and the costs of paying claims and all related expenses. (Note these are included in the FASB PDR and excluded in FASAB calculation of loan and loan guarantee subsidy expense)
    - iv. Unamortized capitalized acquisition costs (included by FASB)
    - v. Expected maintenance costs (included by NAIC SAP) associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.
    - vi. Existing reserves
    - vii. Expected policyholder dividends (included by FASB)

### **Staff Analysis:**

Staff believes existing federal standards are unclear regarding recognition of “contingencies” for insurance programs. The result is that users may not understand the amounts presented as “liabilities.” For example, the term “premiums deficiency reserves (PDR)” is used in disclosures about crop insurance but not in other insurance disclosures such as flood, as evidenced below.

### **FEDERAL CROP INSURANCE CORPORATION/RISK MANAGEMENT:**

Staff determined that Crop Insurance uses “reserves for premium deficiency” to account for appropriations that may be needed to pay for estimated losses on insurance claims not covered by premiums.

Per the Crop task force members—The premium deficiency is accrued as a debit to 680000, *Future Funded Expenses* and a credit to 2660000, *Actuarial Liabilities for Federal Insurance and Guarantee Programs*.

Below is Crop’s disclosure to reconcile estimated insurance claims.

**Note 6: ESTIMATED LOSSES ON INSURANCE CLAIMS<sup>5</sup>**

The following table summarizes the activity in the accrual for estimated losses on insurance claims:

Estimated Losses in millions	2013	2012
Balance as of October 1	\$ 18,376	\$ 9,531
Incurred related to:		
Current Year	8,874	20,172
Prior Year	(2,630)	(1,619)
Total Incurred	6,244	18,553
Paid related to:		
Current Year	(3,928)	(1,885)
Prior Year	(15,404)	(7,698)
Total Paid	(19,332)	(9,583)
<b>Reserve for Premium Deficiency</b>	<b>(86)</b>	<b>(125)</b>
Net balance as of September 30	\$ 5,202	\$ 18,376

**Unearned Revenue<sup>6</sup>**

Premium revenue is comprised of producer paid premium. Producer paid premium is recognized as earned proportionately over each crop’s growing season. The portion of producer paid premium not recognized at the conclusion of the fiscal year is classified as “unearned revenue, with the public” in the consolidated balance sheets. Premium subsidy is recognized as earned when expended.

<sup>5</sup> Federal Crop Insurance Corporation/Risk Management Agency’s Financial Statements for Fiscal Years 2013 and 2012, page 32: <http://www.usda.gov/oig/webdocs/05401-0003-11.pdf>

<sup>6</sup> FEDERAL CROP INSURANCE CORPORATION/RISK MANAGEMENT AGENCY’S FINANCIAL STATEMENTS FOR FISCAL YEARS 2013 AND 2012, pages 29-30.

The sum of producer paid premium and premium subsidy has been calculated using generally accepted actuarial methods to attain a forecasted break-even loss ratio of 1.0. To the extent premium subsidy is not expended, no unearned revenue is recorded in the consolidated balance sheets. As a result, the expected claim costs and claims-adjustment expenses exceed the related unearned revenue. A **premium deficiency** is therefore recognized in the consolidated balance sheets by accruing a liability recorded as an Estimated Loss on Insurance Claims Liability for the excess amount.

The reserve for premium deficiency is negative due to the reversal of prior year estimate being larger than the current year estimate. The chart below illustrates the entries to the liability account.<sup>7</sup>

Reserve for Premium Deficiency

	Fiscal Year 2013	Fiscal Year 2012
Reinsurance Year 2011 PDR (reversal)		(1,250,324,618.17)
Reinsurance Year 2012 PDR		1,125,801,387.92
Reinsurance Year 2012 PDR (reversal)	(1,125,801,387.92)	
Reinsurance Year 2013 PDR	1,039,780,314.88	
	(86,021,073.04)	(124,523,230.25)

**NATIONAL FLOOD INSURANCE PROGRAM (NFIP):**

Another example of inconsistency can be seen in the Department of Homeland Security (DHS) notes on NFIP. While Required Supplementary Information Note 4—Risk Assumed Information discusses the “unearned premium reserve” and “unearned premium liability” it is very a general discussion about a premium deficiency. The term premium deficiency is not mentioned specifically. In addition, while note 20-Insurance Liabilities does provide a schedule showing the change in the liability balance, there is no mention of an unearned premium reserve or unearned premium liability.

**4. Risk Assumed Information<sup>8</sup>**

The Department has performed an analysis of the contingencies associated with the **unearned premium reserve** for the NFIP. This FY 2013 estimate represents losses that might occur in FY 2014 on policies that were in-force as of September

<sup>7</sup> Emails from Crop, 9/18/14 and 9/25/14

<sup>8</sup> U.S. Department of Homeland Security, FY 2013 Agency Financial Report, Note 4, page 154

30, 2013. The calculation utilizes the current estimate of the long-term average loss year, which includes an estimate of a rare but catastrophic loss year. A large portion of the long-term average loss year is derived from those catastrophic years.

The NFIP subsidizes rates for some classes of policyholders. These subsidized rates produce a premium less than the loss and loss adjustment expenses expected to be incurred during the long-term average loss year described above. Accordingly, there is a risk that paid flood losses during the remainder of the term for those subsidized policies will exceed the **unearned premium liability**.

The underlying calculation estimates the amount of subsidy in the total rates, removes the expense load, and applies the results to the **unearned premium reserve**. A range is developed and applied to the results of the calculation of unpaid expected losses by \$550 to \$600 million. Actual flood losses are highly variable from year to year. For the majority of years, the unearned premium reserve for the NFIP is adequate to pay the losses and expenses associated with the unearned premium. In those years with catastrophic flooding, the reserve and the average across all years will be inadequate because of the subsidies in premium levels.

**Note 20. Insurance Liabilities<sup>9</sup>**

The insurance liability for unpaid losses and related loss adjustment expenses and amounts paid for the year ended September 30 consisted of the following (in millions):

	<u>2013</u>	<u>2012</u>
Beginning Balance	\$ 833	\$ 3,537
Change in Incurred Losses		
Change from Events of the Current Year	9,190	1,083
Change from Events of Prior Years	(195)	(1,519)
Less: Amounts Paid During Current Period		
Paid for Events of the Current Year	(8,569)	(369)
Paid for Events of Prior Years	<u>(562)</u>	<u>(1,899)</u>
Total Insurance Liability	<u>\$ 697</u>	<u>\$ 833</u>

Insurance liabilities consist primarily of NFIP insurance liabilities. The NFIP insurance liability represents an estimate of NFIP based on the loss and loss adjustment expense factors inherent in the NFIP insurance underwriting operations experience and expectations. Estimation factors used by the

<sup>9</sup> U.S. Department of Homeland Security, FY 2013 Agency Financial Report, Note 20, page 110

insurance underwriting operations reflect current case basis estimates and give effect to estimates of trends in claim severity and frequency. These estimates are periodically reviewed, and adjustments, reflected in current operations, are made as necessary.

## CURRENT CONCEPTS & STANDARDS RELEVANT TO PREMIUM DEFICIENCY RESERVES – FEDERAL AND COMMERCIAL:

SFFAS 5 explicitly discusses three components of the liability – unpaid claims incurred and reported, claims incurred but not reported, and contingencies (consistent with the general contingency liability guidance for probably and measurable losses).

104. All federal insurance and guarantee programs (except social insurance and loan guarantee programs) should recognize a liability for unpaid claims incurred, resulting from insured events that have occurred as of the reporting date. The standard requires recognition of the liability that is known with certainty plus an accrual for a contingent liability recognized when an existing condition, situation, or set of circumstances involving uncertainty as to possible loss exists and the uncertainty will ultimately be resolved when one or more probable future events occur or fail to occur; a future outflow or other sacrifice of resources is probable; and the future outflow or sacrifice of resources is measurable. Insurance and guarantee programs should recognize as an expense all claims incurred during the period, including, when appropriate, those not yet reported and contingencies that meet the criteria for recognition. Life insurance programs --- [omitted]. (See Contingencies section for the criteria for disclosure of a contingent liability.)

In contrast to FASAB SFFAS 5, the Financial Accounting Standards Board (FASB) explicitly addresses recognition of a liability for “premium deficiency reserves.”

The AICPA’s Accounting and Auditing Guide for Property and Life Insurance (AAG PLI) summarizes the FASB ASC as follows:

3.84 A premium deficiency relating to short duration insurance contracts indicates a probable loss on premiums yet to be earned. FASB ASC 944-60-25-4 states that a premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs [ftn 4] exceeds related unearned premiums.

Footnote 4 Per the FASB Accounting Standards Codification glossary, maintenance costs are defined as costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

3.85 As discussed in FASB ASC 944-60-25-3, insurance contracts shall be grouped consistently with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists. FASB ASC 944-60-25-5 states that a premium deficiency shall first be recognized by charging unamortized acquisition costs to expense to the extent required to eliminate the deficiency. As noted in FASB ASC 944-60-25-6, if the premium deficiency is greater than unamortized acquisition costs, a liability shall be accrued for the excess deficiency.

The AAG PLI illustrates premium deficiency calculations (see Appendix B). In addition, the AAG PLI describes treatment of high severity infrequent events and events occurring after the balance sheet date:

3.94 In addition, if current year reported loss and loss expense ratios are used to project anticipated losses, the entity should exclude from the ratios the impact of reserve development on prior accident years, as well as large or unusual current accident year events. FASB ASC 944-60-25 does not provide explicit guidance on whether to include estimates in the premium deficiency calculation for losses relating to actual events occurring subsequent to the balance sheet date. In practice, this is accounted for in multiple ways, with the common starting point being that the event is probable of occurring at the balance sheet date. One method is to include estimates for losses occurring subsequent to the balance sheet date, using all available information up through the date that the financial statements are issued. Another method is to include estimates for losses if the extent of the damage is reasonably estimable at the balance sheet date, using only information that theoretically existed at the balance sheet date. The Financial Reporting Executive Committee believes that an entity's determination of how to account for losses relating to actual events occurring subsequent to the balance sheet date within the premium deficiency calculation would be a policy decision that should be applied consistently and disclosed as follows:

- a. Probable at the balance sheet date, using all available information up through the date that the financial statements are issued. Estimates should be based on the entity's expectation of the future loss events that are probable at the balance sheet date, using all available information up through the date that the financial statements are issued. However, the estimates should not include losses relating to actual events occurring subsequent to the balance sheet date that were not probable at the balance sheet date. Therefore, estimates for infrequent, high severity events that are included in expected loss and loss expense ratios based on historical events and trends expected to continue should be included, but the expected cash flows should not include actual events, such as hurricanes or ice storms, that occur subsequent to the balance sheet date and that were not probable of occurring at the balance sheet date. However, in those rare circumstances when an infrequent, high severity event is probable at the balance sheet date and expected to occur in the near future, expected losses relating to that probable event should be

included in the premium deficiency calculation. For example, potential losses from a hurricane sitting off the coast of Florida at period end that hits the coast and causes damage shortly thereafter in the subsequent accounting period would rarely meet the criteria of being probable. In those instances, when the hurricane did hit, expected cash flows relating to the hurricane would be included in the premium deficiency calculation, using all available information up through the date that the financial statements are issued.

b. Probable and reasonably estimable at the balance sheet date, using only information that theoretically existed at the balance sheet date. Estimates should be based on the entity's expectation of future loss events that are probable and reasonably estimable at the balance sheet date, using only information that theoretically existed at the balance sheet date. However, the estimates should not include losses relating to actual events occurring subsequent to the balance sheet date that were not probable and reasonably estimable at the balance sheet date. Therefore, estimates for infrequent, high severity events that are included in expected loss and loss expense ratios based on historical events and trends expected to continue should be included, but expected cash flows should not include actual events, such as hurricanes or ice storms, that occur subsequent to the balance sheet date that were not both probable of occurring and reasonably estimable at the balance sheet date. The estimate should only be based on information that theoretically existed at the balance sheet date but not thereafter. In general, it would be very rare to have a situation that would meet both criteria of being probable of occurring and being able to reasonably estimate the extent of the damage, using information that theoretically existed at the balance sheet date. For example, potential losses from a hurricane sitting off the coast of Florida at period end that hits the coast and causes damage shortly thereafter in the subsequent accounting period would very rarely meet the criteria of being both probable and reasonably estimable, using information that theoretically existed at the balance sheet date. As a result, the hurricane would not be included in a premium deficiency calculation.

In addition to accounting standards issued by FASB, insurance companies also have to follow the:

National Association of Insurance Commissioners (NAIC), Statutory Accounting Principles (SAP), which states that:<sup>10</sup>

Statutory Accounting Principles are designed to assist state insurance departments in the regulation of the solvency of insurance companies. The ultimate objective of solvency regulation is to ensure that policyholder, contract

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<sup>10</sup> [http://www.naic.org/cipr\\_topics/topic\\_statutory\\_accounting\\_principles.htm](http://www.naic.org/cipr_topics/topic_statutory_accounting_principles.htm) Last Updated 7/28/2014

holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide a margin of safety. With the objective of solvency regulation, SAP focuses on the balance sheet, rather than the income statement, and emphasizes insurers' liquidity.

Although SAP utilizes the framework established under U.S. GAAP (Generally Accepted Accounting Principles), the SAP and GAAP accounting standards have distinct differences. In contrast to the SAP focus for solvency regulation, the mission of the Financial Accounting Standards Board (FASB) when developing US GAAP is to establish and improve standards of financial accounting and reporting that provides decision-useful information to investors and other users of financial reporting.

SAP is developed in accordance with the concepts of consistency, recognition and conservatism:

- **Conservatism:** Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency.
- **Recognition:** The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet by rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
- **Consistency:** The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles.

In March 2004, the **Actuary Standards Board** issued the Actuary Standard of Practice (ASOP) No. 42, *Determining Health and Disability Liabilities Other Than Liabilities for Incurred Claims*, which states that:

2.9 Premium Deficiency Reserve—A liability established when, for a period of time, the value of future premiums, current reserves, and unpaid claims liability are less than the value of future claim payments and expenses plus the anticipated liabilities at the end of the period.

3.4 Considerations for Determining Premium Deficiency Reserves—The actuary should establish a premium deficiency reserve when such a reserve is required. Premium deficiency reserves are typically established for financial reporting

purposes. They may also be established for other purposes such as management reporting. The actuary commonly performs a gross premium valuation in order to determine whether or not a deficiency exists.

3.4.1 General Considerations—When determining deficiency reserves, the actuary should take into account the following:

- a. Assumptions in the Aggregate—The actuary should use assumptions that are reasonable in the aggregate.
- b. Exposure—The actuary should consider reasonable increases and decreases in exposure units over the time period of the calculation in the premium deficiency reserve calculation. This parameter should reflect changes due to such factors as mortality, lapses, and the impact of expected premium rate changes.
- c. Premium Rate Changes—The actuary should use a premium rate change assumption that is reasonable in relation to the projected claims costs and the risk-assuming entity's expectations. This assumption should take into account factors such as market conditions, regulatory restrictions, and rate guarantees.
- d. Claim Trend—The actuary should take into account the wearing away of durational effects such as risk selection and pre-existing condition limitations, changes in provider agreements, adverse selection due to premium rate increases and plan design, and other factors that affect future claim payments.
- e. Risk-Sharing Arrangements—The actuary should take into account risk sharing arrangements. If the actuary anticipates there will be a payout for risk-sharing arrangements associated with a block of business that is being tested for premium deficiency, the actuary should treat the amount of the payout as an expense. Some of these arrangements require providers to share in losses as well as gains. If such an agreement is in effect and the actuary anticipates there will be losses associated with the block of business being tested, the actuary should include the amount due from the providers to offset the losses only to the extent that the actuary reasonably expects the amount due to be collectible.
- f. Interest Rates—The actuary should use interest rates in the present value calculation that are reasonable and consistent with the purpose for which the reserve is being calculated.
- g. Reinsurance—The actuary should consider the expected effects of reinsurance and changes in reinsurance premiums in determining the premium deficiency reserve.

h. Taxes—The actuary should consider the effect of losses assumed in the calculation of the premium deficiency reserve on the risk-assuming entity's taxes and may include a tax credit in the calculations where appropriate.

i. Expenses—The actuary should consider total expenses of the risk-assuming entity in establishing a premium deficiency reserve and should consider whether the expenses allocated to the block of business are reasonable for the purpose of determining premium deficiency reserves.

3.4.2 Additional Considerations for Financial Reporting—When determining premium deficiency reserves for financial reporting, the actuary should consider the following:

a. Blocks of Business—In order to determine whether or not a premium deficiency exists, the actuary should consider blocks of business in a manner consistent with applicable financial reporting requirements. The characteristics of a block of business may include, but are not limited to, benefit type (for example, major medical, preferred provider organization, or capitated managed care), contract type (for example, group or individual policies), demographic grouping (for example, group size or geographical area), and length of rate guarantee period. Whatever criteria are used, a block of business should be large enough so that its financial results are material relative to the risk-assuming entity as a whole. The actuary may need to establish a premium deficiency reserve for a block of business where a premium deficiency exists even if the contract period has not started.

b. Time Period—The actuary should take into account any applicable law, regulation, or other binding authority in establishing the time period of the calculation. The valuation date is the beginning of the time period used to project losses from a block of business. The end of the time period is generally the earlier of the end of the contract period or the point at which the block no longer requires a premium deficiency reserve.

In March 2007, the **American Academy of Actuaries** issued their position on health PDRs in the *Premium Deficiency Reserves Discussion Paper*.

## Section II – General PDR Background

### A. Purpose of PDRs.

Page 4: We understand from the AP&P<sup>11</sup> that a PDR supports this objective to aid in the measurement of a reporting entity's financial condition in that:

<sup>11</sup> NAIC Accounting Practices and Procedures (AP&P)

- The PDR is a tool for solvency regulation, helping to ensure that a reporting entity's contractual obligations will be adequately funded.
- The PDR accomplishes that purpose by establishing a reserve that reduces the reporting entity's statutory capital and surplus, by an amount equal to the excess of future contracted benefits and associated expenses over future revenues and current contract reserves.
- The PDR helps identify situations where the reduction in statutory surplus could result in potential impairment with regard to the reporting entity's ability to meet its obligations.

*GAAP Financial Reporting.*<sup>12</sup>

GAAP has a somewhat different focus than statutory reporting. While, strictly speaking, the term "premium deficiency reserve" is not defined, Statement of Financial Accounting Standards No. 60 (FAS60), *Accounting and Reporting by Insurance Enterprises*, discusses in some detail the premium deficiency event and its associated accounting treatment for GAAP, separating its discussion between short-duration contracts and long-duration contracts. GAAP is concerned primarily with a reporting entity's value to its current and potential owners, and with providing financial information about the entity's ongoing operations to such owners and other interested parties. Accordingly, the GAAP presentation of a reporting entity's balance sheet is generally intended to reflect the economic value of the entity's financial resources and obligations, rather than focus on the entity's potential difficulties in meeting its obligations. Furthermore, GAAP places much more importance on a reporting entity's income statement, from a going-concern perspective, because a great deal of the entity's value — to its owners, its customers, and its potential business partners — is derived from its ability to engage in profitable operations in the future.

In this context, the purpose of determining a PDR is to ascertain whether the reporting entity has assumed an unfunded financial obligation, and to represent the effect of such an obligation on the entity's financial condition. The distinction between that purpose and the statutory-perspective purpose cited previously may be neither apparent nor sharp. The two perspectives do, however, lead to different PDR requirements:

- GAAP reporting, much more than statutory financial reporting, is concerned with the expected results of future operations. As such, the impact of recognizing losses on only a portion of the entity's business, and shifting the effects of such losses from future reporting periods to the present, may be less misleading than if the focus is predominantly on whether the entity is already at risk of near-term insolvency. If the current recognition of such potential losses is viewed as eliminating "noise" from

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<sup>12</sup> The term GAAP refers to FASB standards

projections of future earnings, then the concerns related to current recognition may be offset by the improved perspective on the overall picture, including future earnings. Although recognizing the PDR in the current period reduces current profitability, it results in improved representation of future earnings.

- From a balance sheet perspective, a PDR for a subset of the business may not be as significant as in the statutory context. For example, there is no GAAP equivalent of riskbased capital (RBC) that may be affected by establishing a PDR. The recognition of future contingent losses in the current GAAP balance sheet, however, could have a negative impact on debt covenants or other contractual commitments the reporting entity has entered into, and fail to meet shareholder expectations related to current period earnings levels or earnings growth.

In summary, the GAAP purpose for PDRs is the recognition and appropriate disclosure of a contingent obligation that may affect an interested person's judgment of the financial value and ongoing financial vitality of a business enterprise...

Page 7: From the standpoint of solvency concerns —from the standpoint of statutory financial reporting— the above considerations lead the work group to form the following three principles.

Principle 1: Situations that result in a PDR being established include the following:

- A block of business will experience losses over the near term, either because of overall premium inadequacy for that block, or because the losses on a particular subset within the block will exceed the profits on the other subsets.
- A block of business will be profitable in the near term, but long-term guarantees will cause it to be unprofitable over the projection period.

Principle 2: The PDR should be determined to minimize "false positives." That is, no PDR should be required unless there is a meaningful potential for loss.

Principle 3: The PDR also should be determined to minimize "false negatives." That is, a PDR should be required whenever there is an expectation for loss.

## Page 11: Section III. Financial Reporting Impacts

The purpose of the PDR is to serve as a tool for solvency regulation, helping to ensure that guarantees made by a reporting entity will be adequately funded. The PDR accomplishes that by withholding from the entity's net worth an amount to fund the entity's future benefits and expenses. Since a PDR helps identify situations in which the entity's future statutory net worth could become impaired, the recognition of the potential impairment will be transferred from the future to the present, via the establishment of the PDR. Thus the PDR affects not only the balance sheet, but also the income statement.

The establishment of a PDR will affect reported net income by effectively moving losses from one reporting period to an earlier period...

In May 1988, the **Casualty Actuarial Society** issued: *Discussion Papers Evaluating Insurance Company Liability*. Below is the chapter on *Premium Deficiency Reserves*:<sup>13</sup>

Staff recognizes the date of the report, however has included it for the definitions, especially the one for "Expected Claim and Claim Adjustment Expenses," since that seems to be an ambiguous term among subject matter experts polled.

### 2.1 Measurement of Deferred Costs

The purpose of the premium deficiency is to recognize that a liability in excess of the unearned premium reserve has been incurred. To assess the amount of this excess liability it is necessary to estimate the deferred costs which it is intended to cover. Four major costs are explicitly defined by the Issues Paper':

2.1.1 Acquisition Costs: Costs that vary with and are primarily related to acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting expenses and policy issue costs, and medical and inspection fees).

2.1.2 Maintenance Costs: Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

2.1.3 Expected Claim and Claim Adjustment Expenses: Claims expected to occur subsequent to a particular date (ordinarily, the balance sheet the expiration of the policies in force (unexpired portion of the policies).

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<sup>13</sup> <http://www.casact.org/search/?q=88dpp>, page 436

Claim adjustment expenses to be incurred in the course of settling expected claims.

#### 2.1.4 Policyholder Dividends

[Policyholder dividends traditionally reflect a share in the profit of an insurer's business returned to its policyholders. For marketing reasons, dividends may be declared even in unprofitable situations, and thus may enter into the premium deficiency calculation.]

The above highlights the more detailed guidance available relating to private sector reporting of premium deficiencies (contingencies). While this guidance is available to federal entities, private sector GAAP guidance has an overriding objective of aiding users in projecting cash flows in order to value the enterprise's profits, and NAIC SAP is more concerned with the insurance company's solvency. Staff recommends finding a middle ground between private sector GAAP and NAIC SAP to recognize and disclose a liability for premium deficiency consistently across federal insurance programs.

**QUESTION IV: Does the Board agree with (1) separating the liability now required by SFFAS 5 into two components—liability for unpaid claims and liability for premium deficiency, and (2) more clearly addressing recognition of contingent liabilities by expanding federal GAAP for federal insurance programs.**

This would require expanding federal GAAP for federal insurance programs to potentially include guidance for:

1. Defining a liability for premium deficiency in addition to the liability for unpaid insurance losses
2. Developing measurement guidance regarding:
  - a. The unit of analysis (that is, what blocks or groups of insurance programs should be used to test for premium deficiencies)
  - b. The projection period (for example, the life of current agreements in the block of insurance programs and/or any additional period during which renewal is guaranteed at specified rates)
  - c. The flows to be included in the analysis:
    - i. Expected future benefits (including guidance regarding treatment of subsequent events)
    - ii. Unearned premiums
    - iii. Expected claim adjustment expenses which include any direct expenses incurred such as legal and adjusters' fees, and the costs of paying claims and all related expenses. (note these are included in the FASB PDR and excluded in FASAB calculation of loan and loan guarantee subsidy expense)

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- iv. Unamortized capitalized acquisition costs (included by FASB and NAIC SAP)
  - v. Expected maintenance costs (included by NAIC SAP) associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.
  - vi. Existing reserves
  - vii. Expected policyholder dividends (included by FASB)
- d. Selection of discount rates
- 3. Disclosing information to aid the reader in understanding the amounts recognized and the related uncertainty.

**V. Review and Approve the Wording of the Proposed Standards:**

See Attachment 1 for proposed standards encompassing the decisions made at the August 2014 meeting.

The following sections have been omitted: executive summary, questions for respondents, introduction, financial report of US disclosures, basis for conclusion, and illustrations.

**Question V: Does the board approve the wording of the proposed standards.**

## **QUESTIONS FOR THE BOARD:**

Question I: Does the board approve requiring a reference to the disclosure for borrowing authority, borrowing, and interest expense from the insurance notes?

Question II: Does SFFAS 7, paragraphs 36-37 provide enough guidance to allow a reference from the insurance standards for unearned revenue? Does the board think this reference to unearned revenue provides enough guidance to allow a reference from the insurance standards.

Question III: Does the Board approve including claim adjustment expenses in insurance program liabilities?

Question IV: Does the Board agree with (1) separating the liability now required by SFFAS 5 into two components—liability for unpaid claims and liability for premium deficiency, and (2) more clearly addressing recognition of contingent liabilities by expanding federal GAAP for federal insurance programs.

Question V: Does the board approve the wording of the proposed standards?

## **NEXT STEP:**

Continue developing the proposed exposure draft.

## **MEMBER FEEDBACK:**

Please contact me as soon as possible to convey your questions or suggestions. Communication before the meeting will help me to prepare answers to your questions in order to make the meeting more productive. You can contact me by telephone at 202-512-7356 or by e-mail at [gilliamr@fasab.gov](mailto:gilliamr@fasab.gov) with a cc to [paynew@fasab.gov](mailto:paynew@fasab.gov)

# TAB H – Attachments

## Risk Assumed: Insurance Programs

<b>#</b>	<b>Attachment</b>	<b>Page</b>
1	Proposed Insurance Programs Standards: Scope, Definitions, Recognition and Measurement, and Disclosures	2
2	Borrowing Disclosures for Insurance and Non Insurance Programs	10

# **TAB H**

## **– Attachment 1 –**

**Proposed Insurance Programs Standards:**  
Scope, Definitions, Recognition and Measurement, and Disclosures

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## PROPOSED STANDARDS

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### SCOPE

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1. This Statement applies to federal entities that present general purpose federal financial reports (GPFFRs), including the consolidated financial report of the U.S. Government (CFR), in conformance with generally accepted accounting principles (GAAP), as defined by paragraphs 5 through 8 of Statement of Federal Financial Accounting Standards (SFFAS) 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*.
2. This Statement provides general principles that should guide preparers of GPFFRs in accounting for and reporting on insurance programs.
3. This Statement rescinds the section: Insurance and Guarantee Programs in Federal Financial Accounting Standards (SFFAS) 5, *Accounting for Liabilities of The Federal Government*, paragraphs 97-121.

### DEFINITIONS

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4. **Insurance Programs** Insurance Programs are authorized by law to accept all or part of the risk for losses incurred by a designated population of beneficiaries as a result of an adverse event by financially compensating them.
  - a. **Criteria for Insurance Programs**
    - i. Insurance programs are administered by an agency established to do so or within an agency that administers many programs.
    - ii. Insurance programs collect exchange or non-exchange revenue that may be earned through, but is not limited to, any or all of the following: premiums,<sup>1</sup> fees paid, assessments, excise taxes, penalties and/or fines, recoveries,<sup>2</sup> interest received from investments and/or receivables, and/or budget authority including appropriations and borrowing authority.<sup>3</sup>

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<sup>1</sup> The term “premiums” will be used to mean premiums, fees paid, excise taxes, penalties and/or fines.

<sup>2</sup> Recoveries may be monies recouped or recovered from: (1) another agency through an indemnification agreement, (2) a third party or commercial insurance company to repay all or part of a loss originally paid for by the program, and/or (3) the sale of salvageable parts through acquisition and disposal or salvage of assets. Recoveries may also be adjustments to already paid claims where the claimant owes money back to the program for a loss that wasn’t realized.

<sup>3</sup> Sources of funding are broad and the charging of “premiums” (or other fees) is not necessary for a program to qualify as an insurance program.

- iii. Insurance programs create a contract, such as an agreement<sup>4</sup> or arrangement, that specifically states:
  - 1. the role the program will play,
  - 2. who the parties are that may contribute funding,
  - 3. the designated population that may be beneficiaries and their responsibilities for receiving compensation for losses,<sup>5</sup>
  - 4. funding requirements,
  - 5. financial compensation to be paid,
  - 6. the adverse event (other than a defaulted debt obligation).
  
- iv. Insurance programs assume risk for the uncertainty of an adverse event occurring and the amount of compensation expected to be paid for losses.
  
- v. Through insurance programs the federal government assumes:
  - 1. all risk for covered losses;
  - 2. partial risk by filling a gap where commercial Insurance companies are not able or willing to provide the insurance; or
  - 3. a timing risk wherein the insurance program provides compensation for losses at the time claims are received and processed in anticipation that future funding sources will be sufficient to cover all or part of past benefits paid.

**b. Excluded from Insurance Programs**

- i. Direct loan and loan guarantee programs as defined in SFFAS 2 (as amended) because defaulted debt obligations are not classified as adverse events for insurance programs.
- ii. Social insurance programs as defined in SFFAS 17 (as amended)<sup>6</sup>
- iii. Disaster relief programs that provide discretionary funding, goods, and/or services.
- iv. Entitlement programs that administer eligibility requirement applications to provide means tested benefits

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<sup>4</sup> Insurance programs may enter into explicit arrangements or agreements with specific individuals, state, local, or foreign governments, other federal agencies, or businesses to carry out their mission.

<sup>5</sup> Beneficiaries may or may not directly participate in an explicit agreement/arrangement prior to becoming eligible to receive compensation. An example where a beneficiary does directly participate and receives compensation is when a U.S. investor purchases risk insurance for political violence and upon an act of politic violence that impacts their business investment may receive compensation. An example where beneficiaries do not directly participate is when a service provider pays premiums directly to a federal insurance program and upon failure provides a list of customers as beneficiaries whom the program may compensate.

<sup>6</sup> Includes unemployment insurance as this is captured also in SFFAS 17.

- v. “Self-insurance,” where the government assumes the risk of loss for some its own activities<sup>7</sup>
  - vi. Programs whose missions are not by statute to provide insurance but which process claims through an administrative or judicial process<sup>8</sup>
  - vii. Programs whose missions are not by statute to provide insurance but which provide security against loss or damage through contractual indemnification of another party<sup>9</sup>
5. **Acquisition costs**—costs that are directly related to the successful acquisition or renewal of insurance contracts.
  6. **Borrowing authority**— is budget authority provided by federal law to incur financial obligations that will result in immediate or future outlays but requires funds to be borrowed to liquidate the obligation.<sup>10</sup>
  7. **Claim**— a demand for payment of a benefit because of the occurrence of an adverse event for which payment is authorized under the insurance program.
  8. **Claim adjustment expenses**—expenses incurred in the course of investigating and settling claims. Claim adjustment expenses include any direct expenses incurred such as legal and adjusters' fees, and the costs of paying claims and all related expenses.
  9. **Incurred but not yet Reported (IBNR)**—IBNR claims are relating to adverse events that have occurred as of the end of the reporting period, but have not yet been reported to the insurance program for settlement.
  10. **Insurance in Force**—the insured amount for all contracts, arrangements, and other agreements entered into by an insurance program that are unexpired as of the end of the reporting period.
  11. **Liability for Unpaid Insurance Claims**—the liability for unpaid claims relates to adverse events that have occurred on or before the end of the reporting period. It includes claims that have been reported but not paid and IBNR claims as well as estimated recoveries.
  12. **Premiums**—Premiums is a general term used to refer to all exchange revenue collected by insurance programs. Programs may refer to their exchange revenue by various terms including but not limited to premiums, assessments, excise taxes, fees, and/or fines.
  13. **Liability for Premium Deficiency**—TBD
  14. **Unearned Premiums**—unearned premiums are exchange revenue received for the period of an insurance policy that extends beyond the end of the reporting period.

<sup>7</sup> GAO, Catalogue of Federal Insurance Activities, GAO-05-265R, page 4.

<sup>8</sup> An example is an administrative settlement of tort claim resulting from military events.

<sup>9</sup> These are administrative settlements for transactions occurring by contractors with Federal Acquisition Regulation authorized indemnification clauses or first responders within programs that do not have a statutory insurance or guarantee mission.

<sup>10</sup> Paraphrased from the FASAB Glossary, Appendix E, page 10

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## RECOGNITION AND MEASUREMENT

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- 15.** Insurance programs other than life insurance programs should recognize a liability for unpaid insurance claims to include:
- a. unpaid claims reported,
  - b. estimated claims incurred but not reported (IBNR),
  - c. less estimated recoveries.
- 16.** The liability for unpaid insurance claims should be recognized for known unpaid claims and for claims incurred but not reported when all of these three conditions are met:
- a. an adverse event occurred before the end of the reporting period (for example, bankruptcy, property damage, drought, or flood);
  - b. a future outflow or other sacrifice of resources is probable; and
  - c. the future outflow or sacrifice of resources is measurable
- 17.** Insurance programs should recognize premiums—earned and unearned--consistent with SFFAS 7, paragraph 36-37, guidance for exchange revenue.

See Section II in the staff memo regarding unearned revenue. If the insurance standards will provide the guidance for unearned revenue instead of a reference to SFFAS 7, paragraph 36-37 then this section would be revised accordingly.

- 18.** Insurance programs should recognize a liability for premium deficiency **TBD**

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## DISCLOSURE REQUIREMENTS

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### COMPONENT REPORTING ENTITY DISCLOSURES

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- 19.** The following information should be disclosed for each major insurance program and collectively for all other insurance programs:
- a. The balance of liabilities for unpaid insurance claims at the beginning and end of each reporting period and an explanation for any event(s) that caused a material change.
  - b. The basis, methods, and/or assumptions used in estimating the liability for unpaid insurance claims.
  - c. A schedule to show the significant components of the change in the liability for unpaid insurance claims. [Staff note: If claims adjustment expense is included in the unpaid claims liability, we will adjust this schedule.] Information in the schedule should provide:
    - i. The beginning balance
    - ii. Incurred claims attributable to insured events of:
      1. the current fiscal year, and
      2. prior fiscal years
    - iii. Paid claims attributable to insured events of:
      1. the current fiscal year, and
      2. prior fiscal years
    - iv. Recoveries and other adjustments
    - v. The ending balance
  - d. For recoveries and other adjustments, the nature and significance of amounts recoverable by other means as well as any significant events affecting estimated recoveries.
  - e. The amount of premiums presented by major type (for example, premiums, assessments, excise taxes, fines) earned during the reporting period(s) and an explanation for event(s) that caused material changes.
  - f. The balance of unearned premiums presented by major type at the end of each reporting period and an explanation for event(s) that caused a material change.

- g. Information regarding premium pricing policies as required by SFFAS 7, paragraphs 46.a. and 46.b. or a reference to another disclosure providing this information.

SFFAS 7  
DISCLOSURES AND OTHER ACCOMPANYING INFORMATION

46. Each reporting entity that provides goods or services to the public or another Government entity should disclose the following:

- (a) differences in pricing policy from the full cost or market pricing guidance for exchange transactions with the public as set forth in OMB Circular No. A-25, User Charges (July 8, 1993), or in subsequent amendments in circulars that set forth pricing guidance;
- (b) exchange transactions with the public in which prices are set by law or executive order and are not based on full cost or on market price;

- h. Appropriations used to settle claims and an explanation for event(s) that caused material changes.
- i. Transfers out to Treasury and an explanation for the transfer.
- j. Borrowing authority, balances, interest expense, repayment requirements, financing sources for repayment, and other terms of borrowing authority used in accordance with SFFAS 1, paragraphs 81, 106, and 112; SFFAS 5, paragraphs: 47-48; and SFFAS 7, paragraphs: 24 and 79 (b) & (c) or a reference to another disclosure providing this information.

See the staff memo for the above referenced paragraphs

- k. Investments and interest income for insurance programs meeting the definition of funds from dedicated collections in SFFAS 27, paragraph 11, or a reference to another disclosure providing this information.

SFFAS 27

Definition of Funds from Dedicated Collections

11. Generally, funds from dedicated collections are financed by specifically identified revenues, provided to the government by non-federal sources, often supplemented by other financing sources, which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities, benefits or purposes, and must be accounted for separately from the Government's general revenues.

The three required criteria for a fund from dedicated collections are:

1. A statute committing the Federal Government to use specifically identified revenues and/or other financing sources that are originally provided to the federal government by a non-federal source<sup>3b</sup> only for designated activities, benefits or purposes;
2. Explicit authority for the fund to retain revenues and/or other financing sources not used in the current period for future use to finance the designated activities, benefits, or purposes; and
3. A requirement to account for and report on the receipt, use, and retention of the revenues and/or other financing sources that distinguishes the fund from the federal government's general revenues.

- l. Changes in laws and/or actuarial assumptions that caused material changes in any of the required disclosures.
- m. Insurance programs should disclose the insurance in force as of the end of the reporting period and an explanation for events that caused a material change.

# **TAB H**

## **– Attachment 2 –**

### **Borrowing Disclosures: Insurance and Non Insurance Programs**

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**INSURANCE PROGRAM EXAMPLE:****U.S. Department of Homeland Security**   
**Borrowing Disclosures for NFIP:****Management's Discussion and Analysis:  
Financial Overview**

Page 37: *Debt* is DHS's second-largest liability, representing 26 percent of total liabilities. This debt results from Department of Treasury loans and related interest payable to fund the National Flood Insurance Program (NFIP) and Disaster Assistance Direct Loan Program operations of FEMA. Total debt increased approximately \$6 billion from FY 2012 due to additional borrowing required to cover insurance claim payments as a result of Hurricane Sandy. Given the current premium rate structure, FEMA will be unable to pay its debt when due, and legislation will need to be enacted to provide funding to repay the Bureau of Public Debt. This is discussed further in Note 15 in the Financial Information section.

***Statement of Budgetary Resources***

Page 40: This statement provides information on the status of the approximately \$95.1 billion in budgetary resources available to DHS during FY 2013. The authority was derived from appropriations of \$64.2 billion, \$13.3 billion in authority carried forward from FY 2012, \$10.9 billion in collections, **and \$6.7 billion of borrowing authority**. The total amount of resources available increased by approximately 15.6 billion from FY 2012. The change is primarily due to substantial increases in FEMA's appropriations and borrowing authority for Hurricane Sandy relief and recovery efforts.

***NOTE 25: Available Borrowing Authority***

Pages 127-128: FEMA has borrowing authority to pay insurance claims as part of the NFIP and to finance CDLs as part of the DADLP. Borrowing authority is budget authority enacted by law to permit an agency to borrow money and then obligate against amounts borrowed for a specified purpose. FEMA is authorized to borrow from the U.S. Treasury up to \$30.4 billion to fund the payment of flood insurance claims and claims-related expenses of NFIP. While the authorizing legislation does provide a cap for amounts that can be borrowed without further authorization, the amounts borrowed at any time are not predetermined, and authority is used only as needed to pay existing obligations for claims and expenses. Insurance premiums collected are used to repay borrowed funds. As of September 30, 2013, \$24 billion has been drawn from Treasury, leaving \$6.4 billion available to be borrowed.

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<sup>11</sup> <http://www.dhs.gov/performance-accountability> Agency financial report for FY2013.

During FY 2013, FEMA received a substantial increase in borrowing authority to pay insurance claims related to Hurricane Sandy. However, ending borrowing authority decreased from FY 2012 due to a change in FEMA's treatment of borrowing authority from definite to indefinite, which resulted in an adjustment to the unobligated balances brought forward, October 1, 2012 and an adjustment to the ending unobligated balances as of September 30, 2013. For additional information, see Note 32, Adjustments to Beginning Balances.

### **Note 15: Debt**

Page 101: DHS's intragovernmental debt is owed to Treasury's Bureau of Fiscal Service and consists of borrowings to finance claims under NFIP and borrowings to finance FEMA's Disaster Assistance Direct Loan Program.

NFIP loans from Treasury are typically for a three-year term. Interest rates are obtained from the Bureau of Fiscal Service and range by cohort year from 0.125 percent to 0.5 percent as of September 30, 2013, and from 0.13 percent to 1.63 percent as of September 30, 2012. Interest is paid semi-annually on March 31 and September 30. The total interest paid was \$103 million and \$89 million as of September 30, 2013 and 2012, respectively. Interest is accrued based on the loan balances reported by Bureau of Fiscal Service. Principal repayments are required only at maturity but are permitted any time during the term of the loan. The loan and interest payments are financed by the flood premiums from policy holders and map collection fees. Given the current rate structure, FEMA will be unable to pay its debt when payment is due. Due to the size of the debt incurred for damages sustained for Hurricanes Katrina, Rita, and Sandy, legislation will need to be enacted to provide funding to repay the Bureau of Public Debt or to forgive the debt.

#### **NOTE 25: Available Borrowing Authority**

Pages 127-128: FEMA has borrowing authority to pay insurance claims as part of the NFIP and to finance CDLs as part of the DADLP. Borrowing authority is budget authority enacted by law to permit an agency to borrow money and then obligate against amounts borrowed for a specified purpose. FEMA is authorized to borrow from the U.S. Treasury up to \$30.4 billion to fund the payment of flood insurance claims and claims-related expenses of NFIP. While the authorizing legislation does provide a cap for amounts that can be borrowed without further authorization, the amounts borrowed at any time are not predetermined, and authority is used only as needed to pay existing obligations for claims and expenses. Insurance premiums collected are used to repay borrowed funds. As of September 30, 2013, \$24 billion has been drawn from Treasury, leaving \$6.4 billion available to be borrowed.

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**NON INSURANCE PROGRAM EXAMPLES:****DEPARTMENT OF AGRICULTURE (USDA)<sup>12</sup>****Note 21. Terms of Borrowing Authority Used**

Page 136: The Secretary of Agriculture has the authority to make and issue notes to the Secretary of Treasury for the purpose of discharging obligations for RD's [Rural Development (RD)] insurance funds and CCC's [Commodity Credit Corporation (CCC)] nonreimbursed realized losses and debt related to foreign assistance programs. The permanent indefinite borrowing authority includes both interest bearing and non-interest bearing notes. These notes are drawn upon daily when disbursements exceed deposits. Notes payable under the permanent indefinite borrowing authority have a term of one year. On January 1 of each year, USDA refinances its outstanding borrowings, including accrued interest, at the January borrowing rate.

In addition, USDA has permanent indefinite borrowing authority for the foreign assistance and export credit programs to finance disbursements on post-credit reform, direct credit obligations, and credit guarantees. In accordance with the Federal Credit Reform Act of 1990 as amended, USDA borrows from Treasury on October 1, for the entire fiscal year, based on annual estimates of the difference between the amount appropriated (subsidy) and the amount to be disbursed to the borrower. Repayment under this agreement may be, in whole or in part, prior to maturity by paying the principal amount of the borrowings plus accrued interest to the date of repayment. Interest is paid on these borrowings based on weighted average interest rates for the cohort, to which the borrowings are associated. Interest is earned on the daily balance of uninvested funds in the credit reform financing funds maintained at Treasury. The interest income is used to reduce interest expense on the underlying borrowings.

USDA has authority to borrow from the Federal Financing Bank (FFB) in the form of Certificates of Beneficial Ownership (CBO) or loans executed directly between

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<sup>12</sup> <http://www.ocfo.usda.gov/usdarpt/usdarpt.htm>

the borrower and FFB with an unconditional USDA repayment guarantee. CBO's outstanding with the FFB are generally secured by unpaid loan principal balances.

CBO's outstanding are related to pre-credit reform loans and no longer are used for program financing.

FFB's CBO's are repaid as they mature and are not related to any particular group of loans. Borrowings made to finance loans directly between the borrower and FFB mature and are repaid as the related group of loans become due. Interest rates on the related group of loans are equal to interest rates on FFB borrowings, except in those situations where an FFB funded loan is restructured and the terms of the loan are modified.

Prepayments can be made on Treasury borrowings without a penalty; however, they cannot be made on FFB CBO's, without a penalty.

Funds may also be borrowed from private lending agencies and others. USDA reserves a sufficient amount of its borrowing authority to purchase, at any time, all notes and other obligations evidencing loans made by agencies and others. All bonds, notes, debentures, and similar obligations issued by the Department are subject to approval by the Secretary of the Treasury. Reservation of borrowing authority for these purposes has not been required for many years.

## **Note 22. Available Borrowing Authority, End of Period**

Page 137: Available borrowing authority at September 30, 2013 and 2012 was \$33,411 million and \$33,693 million, respectively.

## **DEPARTMENT OF ENERGY<sup>13</sup>**

### **Combined Statements of Budgetary Resources**

Page 39: The *Combined Statements of Budgetary Resources* identify the Department's budgetary authority. Federal law gives budgetary authority to agencies to incur financial obligations that will eventually result in outlays or expenditures. Budgetary authority that the Department receives includes

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<sup>13</sup> <http://www.energy.gov/cfo/downloads/fy-2013-doe-agency-financial-report>, FY 2013 Agency Financial Report.

appropriations, borrowing authority, contract authority and spending authority from offsetting collections.

## **BORROWING FROM TREASURY**

### **Note 12. Debt**

Page 60: BPA is authorized by Congress, to issue to the U.S. Treasury and have outstanding at any one time up to \$7,700 million of interest-bearing bonds or related debt instruments with terms and conditions comparable to debt issued by U.S. government corporations. The debt may be issued to finance BPA's capital programs, which include Corps and Reclamation direct-funded capital investments. Of the \$7,700 million, \$750 million can be issued to finance Northwest Power Act related expenses and \$1,250 million is restricted for conservation and renewable resources. The Western Area Power Administration has authority to borrow up to \$3.25 billion from Treasury for planning, constructing, financing, operating, or maintaining new or upgraded electric power transmission lines and facilities; and for delivering or facilitating the delivery of power generated by renewable energy.

The Department is authorized to borrow from Treasury if cash previously collected is not enough to cover interest expense and other items related to the loan programs. As of September 30, 2013 the maturity range of the debt was

## **GENERAL SERVICE ADMINISTRATION (GSA)**

### **Note 7: INTRAGOVERNMENTAL DEBT**

#### **A. Lease Purchase Debt**

Page 38: Starting in FY 1991, GSA entered into several agreements to fund the purchase of land and construction of buildings under the FBF lease purchase borrowing authority. Under these agreements, the FBF borrows monies (as advance payments) through the Federal Financing Bank (FFB) or executes lease-to-own contracts to finance the lease purchases. Mortgage loans and construction advances held by the FFB are due at various dates from June 28, 2021, through August 1, 2035, at interest rates ranging from 2.005 percent to 8.561 percent. The program authorizes total expenditures of \$1,945 million for 11 projects. In FYs 2013 and 2012, the FFB made advance payments on behalf of GSA totaling \$0.5 million and \$2 million, respectively. As of September 30, 2013, and 2012, \$26.9 million and \$27.4 million, respectively, of borrowing authority under the lease purchase program remained available for additional advance payments. However, during FY 2013, GSA completed all new borrowing actions related to these projects

and has yet to determine any further use of the remaining authority.

## DEPARTMENT OF EDUCATION<sup>14</sup>

### **Budget Authority**

Page 52-52: ...Borrowing authority is an indefinite budgetary resource authorized under the Credit Reform Act. This resource, when realized, finances the unsubsidized portion of the Direct Loan Program, ECASLA [*Ensuring Continued Access to Student Loans Act of 2008*] Programs, the TEACH [*Teacher Education Assistance for College and Higher Education*] Program, and the **HBCU** [*Historically Black Colleges and Universities*] Capital Financing Program. In addition, borrowing authority is requested in advance of expected collections to cover negative subsidy cost. Treasury prescribes the terms and conditions of borrowing authority and lends to the Credit Financing Account amounts as appropriate. Amounts borrowed, but not yet disbursed, are included in uninvested funds and earn interest. Treasury uses the same weighted average interest rates for both the interest charged on borrowed funds and the interest earned on uninvested funds. The Department may carry forward borrowing authority to future fiscal years provided that cohorts are disbursing loans. All borrowings from Treasury are effective on October 1 of the current fiscal year, regardless of when the Department borrowed the funds, except for amounts borrowed to make annual interest payments...

### **Note 6. Credit Programs for Higher Education: Credit Program Receivables, Net and Liabilities for Loan Guarantees**

Page 63: ...The Department also administers the Historically Black Colleges and Universities (HBCU) Capital Financing Program. Since 1992, this program has given HBCUs access to financing for the repair, renovation, and, in exceptional circumstances, the construction or acquisition of facilities, equipment, and infrastructure through federally insured bonds. The Department has authorized a designated bonding authority to make the loans to eligible institutions, charge interest, and collect principal and interest payments. In compliance with statute, the *Higher Education Act of 1965* (HEA), as amended, the bonding authority maintains

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<sup>14</sup> <http://www2.ed.gov/about/reports/annual/2013report/index.html>

an escrow account to pay the principal and interest on bonds for loans in default.

On March 22, 2013, the Department and representatives from Treasury and OMB jointly offered loan modification terms and conditions to all four HBCU institutions in response to their request for forbearance considerations. In an effort to mitigate the economic effects of the hurricanes and to better serve the interests of the United States and the institutions, the Department has agreed to three components of modifications: forbearance, expense-based repayment, and debt adjustment. As part of the five-year forbearance agreement, the Department will pay on behalf of the institutions: servicing costs due to the Bank of New York Mellon Trust Company; servicing costs due to the designated bonding authority, Rice Capital (Atlanta, GA); and biannual bond principal and interest payments due to the Federal Financing Bank. The loan modification will not reduce the amount owed by the institutions and the Department will become the holder of the aforementioned bonds to the extent of its payments made on behalf of the institutions during the forbearance period...

## DEPARTMENT OF DEFENSE<sup>15</sup>

Page 76: The Department administers the Foreign Military Financing program on behalf of the EOP. This program is authorized by sections 23 and 24 of the *Arms Export Control Act of 1976*, as amended, PL 90-629, as amended, and section 503(a). This program provides loans to help countries purchase U.S. produced weapons, defense equipment, services, or military training. The direct loans and loan guarantees related to Foreign Military Sales are not included in these financial statements, per the Department's agreement with OMB; this information is provided separately as other information.

Page 100: Debt consists primarily of borrowing from the U.S. Treasury for capital improvements to the Washington Aqueduct Project.

### **Other Disclosures**

Page 122: The SBR includes intra-entity transactions because the statements are presented as combined.

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<sup>15</sup> <http://comptroller.defense.gov/FinancialManagement/Reports/afr2013.aspx>

The Department utilizes borrowing authority for the Military Housing Privatization Initiative and the Armament Retooling and Manufacturing Support Initiative. Borrowing authority is used in accordance with [OMB Circular A-129, “Managing Federal Credit Programs.”](#)

## **SMALL BUSINESS ADMINISTRATION<sup>16</sup>**

Page 23: ...SBA’s loans and guaranties are financed by a combination of subsidy appropriations, fees charged to lenders and borrowers, and borrowings from the Treasury...Borrowings are repaid to the Treasury as loans are repaid to the SBA...

Page 24: ...Borrowing Authority increased \$0.4 billion in FY 2013. Disaster borrowing authority initially granted to the SBA was \$3.6 billion, but the SBA returned \$2.2 billion at year-end FY 2013 as it was not needed to fund future credit program operations.

### **Budgets and Budgetary Accounting for Loan Programs**

Page 55: SBA’s loan disbursements are financed by appropriations for long-term loan subsidy cost and borrowings from the Department of the Treasury for the remaining non-subsidized portion of the loans. The Congress may provide one year, multi-year or no year appropriations to cover the estimated long-term costs of the loan programs. The non-subsidized portion of each loan disbursement, financed initially under permanent indefinite authority to borrow funds from the Treasury, is repaid from collections of loan fees, repayments and default recoveries. The Congress authorizes the dollar amount of obligations that can be made for the cost of direct loans and loan guaranties and establishes the maximum amount of loans the SBA can guarantee in its annual appropriation bill.

### **NOTE 9: DEBT**

Page 71: Borrowings payable to the Treasury result from loans provided by the Treasury to fund the portion of direct loans not covered by subsidy appropriations and to fund the payment of downward subsidy reestimates and other credit program disbursements (see Note 15). The SBA makes periodic principal repayments to the Treasury based on the analysis of its cash balances and future disbursement needs.

Borrowings payable to the Federal Financing Bank are the result of its financing of SBA Section 503 Debentures issued prior to 1988.

All debt is intragovernmental and covered by budgetary resources.

## **DEPARTMENT OF TRANSPORTATION<sup>17</sup>**

### **NOTE 11: DEBT**

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<sup>16</sup> <http://www.sba.gov/content/fy-2013-agency-financial-report-afr>

<sup>17</sup> <http://www.dot.gov/mission/budget/2013-agency-financial-report>

Page 82: As part of its credit reform program, DOT borrows from the U.S. Treasury when cash is needed in its financing accounts. Borrowings are needed to transfer the credit subsidy related to downward reestimates from the financing account to the receipt account or when available cash is less than claim payments.

During FY 2013, DOT's U.S. Treasury borrowings carried interest rates ranging from 0.46% to 7.19%. The maturity dates for these borrowings occur from September 2016 to September 2051. Loans may be repaid in whole or in part without penalty at any time. The borrowing from the Federal Financing Bank has an interest rate of 6.4% and matures in May 2015. Borrowings from the U.S. Treasury and the Federal Financing Bank are considered covered by budgetary resources as no congressional action is necessary to pay the debt.

## NATIONAL CREDIT UNION ADMINISTRATION<sup>18</sup>

### ***Borrowing Authority from the U.S. Treasury***

*Page 74:* The NCUSIF has \$6.0 billion in maximum statutory borrowing authority, shared with the TCCUSF, from the U.S. Treasury. As of December 31, 2013 and 2012, the TCCUSF had \$2.9 billion and \$5.1 billion in borrowing outstanding from the U.S. Treasury, respectively; the NCUSIF had no borrowings outstanding. As a result, the NCUSIF had \$3.1 billion and \$0.9 billion, respectively, in available borrowing authority shared with the TCCUSF. The estimated losses and liquidity needs of the TCCUSF are based on the NCUA's expectations and assumptions about the resolution of failed corporate credit unions, including the disposition and recovery value of their assets. Actual losses of the TCCUSF, including the TCCUSF's funding needs, could differ from those estimates. Consequently, additional borrowing for the TCCUSF reduces funds available from this source.

***Borrowing Authority from the CLF*** The NCUSIF also has the ability to borrow from the CLF as provided in the FCU Act. At December 31, 2013 and 2012, the NCUSIF did not have any outstanding borrowing from the CLF. The CLF is authorized by statute to borrow, from any source, an amount not to exceed twelve times its subscribed capital stock and surplus. The CLF had statutory borrowing authority of \$2.9 billion as of December 31, 2013. NCUA maintains a note purchase agreement with Federal Financing Bank (FFB) on behalf of CLF with a maximum principal amount of \$2.0 billion. Under the terms of its agreement, CLF borrows from FFB as needed. Under terms prescribed by the note purchase agreement, CLF executes promissory notes in

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<sup>18</sup> <http://www.ncua.gov/Legal/RptsPlans/AnnRpts/Pages/annualrpt.aspx> NCUA is an insurance program, however, per their disclosures, borrows from the FFB.

amounts as necessary and renews them annually. Advances under the current promissory note can be made no later than March 31, 2014. [74](#)

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# TAB H – Appendices

(Optional Reading for Reference)

## Risk Assumed: Insurance Programs

<b>#</b>	<b>Appendix</b>	<b>Page</b>
A	Risk Assumed - Project Decision History and Milestones	2
B	List to Date of Identified Insurance Programs	7
C	List to Date of Programs Named as “Insurance” but NOT Identified as Insurance Programs	12
D	AICPA Accounting and Auditing Guide—Property and Life Insurance	13

# TAB H – Appendix A –

## Risk Assumed: Insurance Programs Project Decision History and Milestones

### August 2014:

The Board approved changing the name of this phase to Risk Assumed: Insurance Programs.

The Board approved the following definition, criteria, and exclusions:

#### **A. DEFINITION:**

Insurance programs<sup>1</sup> are authorized by law to accept all or part of the risk for losses incurred by a designated population of beneficiaries as a result of an adverse event by financially compensating them.

#### **B. CRITERIA:**

- Insurance programs are administered by an agency established to do so or within an agency that administers many programs.
- Insurance programs collect exchange or non-exchange revenue that may be earned through, but is not limited to, any or all of the following: premiums,<sup>2</sup> fees paid, excise taxes, penalties and/or fines, recoveries,<sup>3</sup> interest received

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<sup>1</sup> Insurance programs will also include guarantee programs not designed for loan/debt guarantees.

<sup>2</sup> The term “premiums” will be used to mean premiums, fees paid, excise taxes, penalties and/or fines.

<sup>3</sup> Recoveries may be monies recouped or recovered from: (1) another agency through an indemnification agreement, (2) a third party or commercial insurance company to repay all or part of a loss originally paid for by the program, and/or (3) the sale of salvageable parts through acquisition and disposal or salvage of assets. Recoveries may also be adjustments to already paid claims where the claimant owes money back to the program for a loss that wasn't realized.

from investments and/or receivables, and/or budget authority including appropriations and borrowing authority.<sup>4</sup>

- Insurance programs create an agreement<sup>5</sup> or arrangement that specifically states:
  - the role the program will play,
  - who the parties are that may contribute funding,
  - the designated population that may be beneficiaries and their responsibilities for receiving compensation for losses,<sup>6</sup>
  - funding requirements,
  - financial compensation to be paid,
  - the adverse event (other than a defaulted debt obligation), and
  - if and how much to place in reserves.
- Insurance programs assume risk for the uncertainty of an adverse event occurring (other than a defaulted debt obligation), and the amount of compensation expected to be paid for losses.
- Through insurance programs the federal government assumes:
  - all risk for covered losses;
  - partial risk by filling a gap where commercial Insurance companies are not able or willing to provide the insurance; or
  - a timing risk wherein the insurance program provides compensation for losses at the time claims are received and processed in anticipation that future funding sources will be sufficient to cover all or part of past benefits paid.

### **C. EXCLUSIONS:**

- a. Loan guarantee programs as defined in SFFAS 2 (as amended) are not included as insurance programs.
- b. Social insurance programs as defined in SFFAS 17 (as amended) are not included as insurance programs.<sup>7</sup>

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<sup>4</sup>Sources of funding are broad and the charging of “premiums” (or other fees) is not necessary for a program to qualify as an insurance program.

<sup>5</sup>Insurance programs may enter into explicit arrangements or agreements with specific individuals, state, local, or foreign governments, other federal agencies, or businesses to carry out their mission.

<sup>6</sup>Beneficiaries may or may not directly participate in an explicit agreement/arrangement prior to becoming eligible to receive compensation. An example where a beneficiary does directly participate and receives compensation is when a U.S. investor purchases risk insurance for political violence and upon an act of politic violence that impacts their business investment may receive compensation. An example where beneficiaries do not directly participate is when a service provider pays premiums directly to a federal insurance program and upon failure provides a list of customers as beneficiaries whom the program may compensate.

- c. Disaster relief programs that provide discretionary funding, goods, and/or services are not included as insurance programs.<sup>8</sup>
- d. Entitlement programs that administer eligibility requirement applications to provide means tested benefits are not included as insurance programs.
- e. “Self-insurance,” where the government assumes the risk of loss for some its own activities<sup>9</sup> is not included as insurance programs.
- f. Programs whose missions are not by statute to provide insurance but which process claims through an administrative or judicial process<sup>10</sup> are not included as insurance programs.
- g. Programs whose missions are not by statute to provide insurance but which provide security against loss or damage through contractual indemnification of another party<sup>11</sup> are not included as insurance programs.

### **April 2014**

The Board revisited the definition and reviewed the similarities and differences with loan guarantee programs under the Federal Credit Reform Act and asked staff to address the following questions/concerns:

- 1) Distinguish insurance/non-loan guarantee programs from loan guarantee programs in the definition.
- 2) What value does the term “non-loan guarantees” add? Can it be removed from the definition?
- 3) Clarify the exclusion of disaster relief programs in relation to the type of compensation provided.

### **March 2014:**

The Board generally agreed with the insurance/non-loan guarantee definition, upon updates from Mr. Dacey, as well as the characteristics and exclusions presented in the staff memo with the understanding that as staff develops the standard and new information is discovered changes are possible and will be finalized within the standard.

<sup>7</sup> Includes unemployment insurance as this is captured also in SFFAS 17.

<sup>8</sup>Criteria updated due to discussion with Chairman Allen concerning funding that was provided to Washington State mud slide victims in addition to goods and services. In addition, it is the Stafford Act that authorizes and regulates disaster relief programs

<sup>9</sup> GAO, Catalogue of Federal Insurance Activities, GAO-05-265R, page 4.

<sup>10</sup>An example is an administrative settlement of tort claim resulting from military events.

<sup>11</sup>These are administrative settlements for transactions occurring by contractors with FAR authorized indemnification clauses or first responders within programs that do NOT have a statutory insurance or guarantee mission.

Staff worked with Mr. Dacey to update some of his concerns with the definition.

The following is the revised definition:

A federal insurance/non-loan guarantee program is a program authorized by law to accept all or part of the risk by financially compensating the designated population for losses incurred as a result of an adverse event as defined by the:

- A. law or otherwise enforceable by law,
- B. related regulations,
- C. agency policies, or
- D. explicit arrangements or agreements

### **December 2013:**

1. The Board agreed with staff's recommendation that it would be difficult to apply the FASB proposed insurance contracts definition to federal insurance/guarantee programs
  - Board requested and Staff agreed to present FASB's proposed definition to the Task Force during the development of the federal definition
2. The Board agreed with Staff's next step to develop a general definition and specific characteristics of insurance and guarantee programs.

### **June 2013:**

1. The Board agreed with staff's recommendation to ask the four federal entities identified to respond to specific questions on FASB's insurance contracts proposal. Staff would use those responses to identify application concerns that would be unique to a federal entity.
2. The Board agreed to further narrow the scope to federal insurance and guarantee **programs** rather than contracts to support the structure of the federal environment and president's budget.

### **February 2013:**

The risk assumed project will be addressed in a **phased approach**:

- Phase I: Insurance and Guarantees
- Phase II: Entitlement Programs, including: national defense, security and disaster response; and other potential effects on future outflows, such as regulatory actions, GSE's, etc.
- Phase III: Commitments and Obligations and other risk areas

# **TAB H – Appendix B –**

## **List to Date of Identified Insurance Programs**

## List to Date of Identified Insurance Programs

[Sources may include 2013+ Budget Appendix and/or Program Annual Reports, GAO-05-265R, and/or Websites]

#	Agency	Insurance Program	Description
1	DOD	War Risk (Marine) Insurance	Providing non-premium war time risk insurance for DOD, which indemnifies FAA by reimbursing them for any loss paid by FAA.
2	FAA/DOD	War Risk (Airline) Insurance	Providing premium third party liability war time risk insurance for commercial airlines. Covers: hull losses; death, injury or property loss to passengers, or crew resulting from an act of war.
3	FCSIC	Farm Credit System Insurance Corporation	Protecting Investors in agriculture and rural America. Insures the timely payment of principal and interest on certain System notes, bonds, and other obligations issued to investors.
4	FDIC	Federal Deposit Insurance Corp	To maintain stability and public confidence in the nation's financial system by insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, and managing receiverships.
5	FEMA	National Flood Insurance Program	To help provide a means for property owners to financially protect themselves. Offering flood insurance to homeowners, renters, and business owners if their community participates in the NFIP.
6	HHS	Early Retiree Reinsurance Program (Scheduled to end in 2014)	Provides reimbursement to participating sponsors of certified plans that provide health benefits to early retirees (age 55 and older and not eligible for Medicaid) their spouses and surviving spouses and dependents. Affordable Care Act (ACA)
7	HHS	Pre-Existing Condition Insurance Plan Program (PCIP) (Scheduled to end in 2014)	Offers the option of two additional months of PCIP coverage to people currently enrolled in PCIP who have not yet found new health insurance coverage. This transitional coverage through March 31, 2014, will allow PCIP enrollees more time to review (ACA) Marketplace plan options and enroll in the coverage that best meets their needs before open enrollment closes in March.
8	HHS/HRSA	National Vaccine Injury Compensation Program	To ensure an adequate supply of vaccines, stabilize vaccine costs, and establish and maintain an accessible and efficient forum for individuals found to be injured by certain vaccines. The VICP is a no-fault alternative to the traditional tort system for resolving vaccine injury claims that provides compensation to people found to be injured by certain vaccines. Excise taxes and interest on investments
9	Division of Coal Mine Workers' Compensation— Labor, HHS, Treasury,	<b>Black Lung Disability Trust Fund</b>	pays workers' compensation and medical benefits to former miners who become totally disabled with pneumoconiosis (a respiratory condition resulting from coal dust exposure that is commonly known as black lung disease). Revenue: Excise taxes on mined coal and borrowings from the U.S. Treasury
10	NCUA	Credit Union Share Insurance Fund	To facilitate the availability of credit union services to all eligible consumers, especially those of modest means, through an objective independent regulatory environment that protects credit union members.

# List to Date of Identified Insurance Programs

[Sources may include 2013+ Budget Appendix and/or Program Annual Reports, GAO-05-265R, and/or Websites]

#	Agency	Insurance Program	Description
11	NRC	Price Anderson - Nuclear Power Plants catastrophe	To ensure that adequate funds would be available to satisfy liability claims of members of the public for personal injury and property damage in the event of a nuclear accident involving a commercial nuclear power plant.
12	OPIC	Overseas Private Investment Corporation	Allows U.S. businesses to take advantage of commercially attractive opportunities in emerging markets, mitigating risk and helping them compete in a global marketplace...Provides innovative, comprehensive, and cost-effective risk-mitigation products to cover losses to tangible assets, investment value, and earnings that result from political perils.
13	OPM	Federal Employees Life Insurance (FEGLI)	A life insurance program for Federal and Postal employees and annuitants,
14	PBGC	Pension Benefit Guarantee Corporation	Protects the retirement incomes of more than 40 million American workers in more than 26,000 private-sector defined benefit pension plans... created to encourage the continuation and maintenance of private-sector defined benefit pension plans, provide timely and uninterrupted payment of pension benefits, and keep pension insurance premiums at a minimum.
15	National Pollution Funds Center, U.S. Coast Guard, U.S. Department of Homeland Security	Oil Spill Liability Trust Fund	The insurance pays valid claims from parties damaged by oil spills in navigable waters and from onshore production and storage facilities when a responsible party does not pay. The damage must have occurred after August 17, 1990. Costs and damages covered by the fund include uncompensated oil removal costs, damages to natural resources, damages to real or personal property, loss of subsistence, loss of government revenues, and increased costs of public services. Any individual, corporation, or state or local government can present a claim for uncompensated removal costs or damages. Revenue: Fines and penalties, cost recoveries, and interest on investments
16		Securities Investor Protection Corporation	SIPC was created under the <a href="#">Securities Investor Protection Act</a> as a non-profit membership corporation. SIPC oversees the liquidation of member broker-dealers that close when the broker-dealer is bankrupt or in financial trouble, and customer assets are missing. In a <a href="#">liquidation under the Securities Investor Protection Act</a> , SIPC and the court-appointed Trustee work to return customers' securities and cash as quickly as possible. Within limits, SIPC expedites the return of missing customer property by protecting each customer up to \$500,000 for securities and cash (including a \$250,000 limit for cash only).  SIPC is an important part of the overall system of investor protection in the United States. While a

# List to Date of Identified Insurance Programs

[Sources may include 2013+ Budget Appendix and/or Program Annual Reports, GAO-05-265R, and/or Websites]

#	Agency	Insurance Program	Description
			<p>number of federal and state securities agencies and self-regulatory organizations deal with cases of <a href="#">investment fraud</a>. SIPC's focus is both different and narrow: restoring customer cash and securities left in the hands of bankrupt or otherwise financially troubled brokerage firms.</p> <p>SIPC was not chartered by Congress to combat fraud. Although created under a federal law, <a href="#">SIPC is not an agency or establishment of the United States Government</a>, and it has no authority to investigate or regulate its member broker-dealers. It is important to understand that <a href="#">SIPC is not the securities world equivalent of the Federal Deposit Insurance Corporation (FDIC)</a>, which insures depositors of <a href="#">insured banks</a>. <a href="http://www.sipc.org">www.sipc.org</a></p>
17	TREASURY	Check Forgery Insurance Fund	Facilitates timely payments for replacement Treasury checks necessitated due to a claim of forgery. To reduce hardships sustained by payees of government checks that have been stolen and forged, settlement is made in advance of the receipt of funds from the endorsers of the checks.
18	TREASURY	Terrorism Insurance Program	Provides for a transparent system of shared public and private compensation for certain insured losses resulting from a certified act of terror.
19	USDA	Federal Crop Insurance Corporation (FCIC)	To provide for nationwide expansion of a comprehensive crop insurance plan...includes products involving yield and revenue insurance, pasture, rangeland and forage, livestock, and other educational and risk
20	U.S. Postal Service	Postal Service Fund (Domestic and Foreign Mail Indemnity Claim Fund)	The fund supports the activities of the U.S. Postal Service Domestic and Foreign Mail Indemnity Program, under which postal customers can purchase up to \$5,000 of insurance against loss or damage to mailed items. Revenue: Fees collected from customers
21	VA	National Service Life Insurance Fund	For World War II era Veterans
22	VA	Service-disabled Veterans Insurance Fund (SDVIF)	For Veterans separated on or after Apr. 25, 1951 who receive a service-connected disability rating
23	VA	Service members' Group Life Insurance Fund (SGLI)	For members of the Uniformed Services on active duty and Ready reservists
24	VA	United States Government Life Insurance (USGLI)	For Veterans who served in World War I and through October 8, 1940
25	VA	Veterans' Special Life Insurance (VSLI)	For Korean War era Veterans separated from service without a service-connected disability
26	VA	Veterans' Reopened Life Insurance (VRI)	For World War II and Korean War Veterans with service-connected or serious non-service-connected
27	VA	Veterans' Mortgage Life Insurance (VMLI)	For severely disabled Veterans who have received specially adapted housing grants.
28	VA	Veterans' Group Life Insurance (VGLI)	For Veterans and separated or retired Reservists who had SGLI while in service

## List to Date of Identified Insurance Programs

*[Sources may include 2013+ Budget Appendix and/or Program Annual Reports, GAO-05-265R, and/or Websites]*

#	Agency	Insurance Program	Description
29	VA	Family Service members' Group Life Insurance (FSGLI)	For spouses and children of members insured under the SGLI program.
30	VA	Service members' Group Life Insurance Traumatic Injury Protection (TSGLI)	Automatic coverage for all SGLI insureds that provides for insurance payments to members who suffer a serious traumatic injury while in service

# TAB H – Appendix C –

## List to Date of Programs Named as “Insurance” but NOT Identified as Insurance Programs

Program Name (from 2014 Budget Appendix)	Agency
State Unemployment <u>Insurance</u> and Employment Service Operations	DOL
State Unemployment <u>Insurance</u> and Employment Service Operations	DOL LABOR
Payment Where Small Business Health <u>Insurance</u> Tax Credit Exceeds Liability for Tax	TREASURY-IRS
Administrative Expenses, Railroad Unemployment <u>Insurance</u> Extended Benefit Payments	Railroad Retirement Board
Railroad Unemployment <u>Insurance</u> Extended Benefit Payments, Recovery Act	Railroad Retirement Board
Federal Disability <u>Insurance</u> Trust Fund	SSA
Federal Old-age and Survivors <u>Insurance</u> Trust Fund	SSA
Administrative Expenses, Children's Health <u>Insurance</u> Program	SSA
Federal Old-age and Survivors <u>Insurance</u> Trust Fund	SSA
Health <u>Insurance</u> Tax Credit Administration	TREASURY
Children's Health <u>Insurance</u> Fund (CHIP)	HHS
HHS: Early Retiree Re <u>insurance</u> Program	HHS
Federal Hospital <u>Insurance</u> Trust Fund	HHS
Federal Supplementary Medical <u>Insurance</u> Trust Fund	HHS
Affordable <u>Insurance</u> Exchange Grants	HHS
Health <u>Insurance</u> Reform Implementation Fund	HHS
Insurance Trust Fund	HHS
Pre-Existing Condition <u>Insurance</u> Plan Program	HHS
Affordable <u>Insurance</u> Exchange Grants	HHS/CMM

# TAB H

## – Appendix D –

### AICPA Accounting and Auditing Guide —Property and Life Insurance—

Checkpoint Contents  
Accounting, Audit & Corporate Finance Library  
Standards and Regulations  
AICPA  
Audit and Accounting Guides  
Property and Liability Insurance Entities

## Chapter 3 - *Premiums*

### Background

**3.01** Insurance entities charge premiums to spread the total cost of similar risks among large groups of policyholders as well as relieve the policyholder of all or part of a risk. Such risks include (a) damage to, or loss of, property caused by various perils (for example, fire and theft), and (b) legal liability resulting from injuries to other persons or damage to their property. The premiums charged plus investment income earned on the premium received are used to cover underwriting expenses, pay the ultimate costs of claims reported on the policies, and provide a profit margin. Premiums are also used as a basis for paying certain underwriting expenses, including commissions to agents, premium taxes, and guaranty fund and other premium-based assessments (expenses are discussed in detail in [chapter 8](#), "Insurance-Related Expenses, Taxes, and Assessments," of this guide).

**3.02** The following are definitions of premiums charged for insurance policies and reinsurance agreements:

**Direct premiums.** Premium income less return premiums arising from policies issued by the entity collecting the premiums and acting as the primary insurance carrier.

**Assumed reinsurance premiums.** Premium income less return premiums arising from contracts entered into to reinsure other insurance companies that provide the related insurance or reinsurance coverage. The accounting for assumed reinsurance premiums is discussed in [chapter 6](#), "Reinsurance," of this guide.

**Ceded reinsurance premiums.** Outgoing premiums less return premiums arising from reinsurance purchased from other insurance entities. The accounting for ceded reinsurance premiums is discussed in [chapter 6](#) of this guide.

**Premium adjustments.** Additional premiums due to or from insureds or reinsurers arising from endorsements, cancellations, experience-rated features, and audits.

**3.03** Premiums are generally established by one of three methods—class or manual rating, individual or judgment rating, or merit rating—which are explained as follows:

- *Class or manual rating* is used primarily to establish rates for various coverages for individuals, families, and small businesses. Based on statistical data, these large groups of similar risks can be classified by a few important and easily identifiable characteristics. These classifications result in standard rates.
- *Individual or judgment rating* is used when the rates for large or unusual risks are established almost entirely by the skill and experience of the rate maker, such as ocean marine risks.
- *Merit rating* is generally used for larger risks of commercial lines and is divided into the following three types:
  - - *Schedule rating* starts with an assumed standard rate, frequently the manual rate, and adjusts the standard rate according to an evaluation of greater or lesser exposure to risk. Schedule rating is often used in fire insurance or commercial properties; however, some companies use this type of rating for all lines of business.
  - - *Experience rating* departs from manual rates based on the insured's past experiences under the coverage. Premiums are adjusted prospectively based on average past experience. Experience rating is widely used in workers' compensation insurance, but some companies use this type of rating for commercial auto and commercial general liability to a lesser extent.
  - - *Retrospective experience rating* differs from experience rating in that it adjusts the premium during the period of coverage based on actual experience during that same period. Policies that are retrospectively rated often specify minimum and maximum premiums and, in effect, may leave a portion of the risk uninsured ( [paragraph 3.04](#) discusses retrospective premium adjustments).

## Types of Premiums Adjustments

**3.04** Adjustments to premiums written and unearned premiums can result from the following:

- *Cancellation* is a complete termination of an existing policy before expiration. Cancellations may generally be requested by the insured or occur by reason of nonpayment of premium. If, at the time of cancellation, the insured has paid more premium than has been earned through the cancellation date, the insured will typically receive a return of premium, subject to a cancellation penalty, when permitted by regulations. If the insured owes additional premium at the time of cancellation, the insurer will bill for the balance due or, if the insurer cannot collect the balance due, write off the premium receivable.
- *Endorsements* are changes in existing policies that may result in additional premiums or return premiums, such as increases or decreases in coverage limits, additions or deletions of property or risks covered, or changes in location or status of insureds.
- *Audit premiums* are premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. An audit may result in an additional premium or a return premium. An example of a policy subject to audit premiums is a workers' compensation policy for which the premium is based on the payroll of the employer.
- *Retrospective premium adjustments* are modifications of the premiums after expiration of the policies. An adjustment is based on the experience of an individual risk during the term of the policy and is

generally subject to maximum and minimum premium limits specified in the policy.

### **Summary of Premium Transaction Flow**

**3.05** The premium cycle normally includes the following functions that generate most premium-related transactions:

- Evaluating and accepting risks, including the evaluation of reinsurance needs
- Issuing policies, including coding and policy maintenance
- Billing and collecting premiums
- Paying commissions and other costs of acquiring business
- Financial and statistical reporting

**3.06** Rates used by an insurance entity are based on the entity's experience by line of insurance or the industry loss experience compiled by advisory rating organizations, which are subject to supervision and regulation by state insurance departments. The principal rating organizations are the National Council on Compensation Insurance, Inc. (NCCI) for workers' compensation insurance; the Surety & Fidelity Association of America; surplus lines associations; and the Insurance Services Office for all other property and liability lines of insurance.

**3.07** The states regulate insurance premium rates to ensure that premium rates shall not be inadequate, excessive, or unfairly discriminatory. In a 1944 decision, the Supreme Court held that insurance is interstate commerce and, as such, is subject to regulation by the federal government. However, in 1945, Congress passed the McCarran-Ferguson Act, which exempts the insurance business from antitrust laws. Although Congress insisted that the federal government has the right to regulate the insurance industry, it stated in the McCarran-Ferguson Act that the federal government would not regulate insurance as long as state legislation provided for the supervision of insurance companies, including rate making. All states have passed legislation requiring insurance commissioners to review, with or without prior approval, most rates charged by insurance companies. An entity must file most rates with the insurance department of each state in which it is authorized to do business. A number of states also require formal or tacit approval of rates by respective state insurance departments.

### ***Evaluating and Accepting Risks***

**3.08** The evaluation and risk accepting function has three general objectives: to evaluate the acceptability of the risk, to determine the premium, and to evaluate the entity's capacity to retain the entire risk.

**3.09** To initiate new business, companies may solicit consumers directly, such as with some personal lines insurance, or through a producer, such as an agent or a broker. Whether solicited directly or through a producer, sales employees and underwriters of the insurance entity must have the appropriate state licenses. If new business is sold directly to the consumer, the insurance entity typically obtains information over the phone or through the Internet and provides the applicant with a quote. If the quote is accepted, the applicant is required to send in a signed application to complete the underwriting process. If new business is submitted through an agent or a broker, the producer submits to the entity an application for a policy, often with a deposit from the customer for a portion of the estimated premium. The cash is recorded in a clearing (suspense) account and deposited, and the application is either forwarded to the

entity's underwriting department for evaluation or reviewed against fully automated underwriting criteria. If the application is sent electronically, the payment is typically sent separately to a lockbox or remittance operation. The risks of a potential new policy are evaluated in accordance with the entity's procedures; these may include a review of the exposure and potential for loss based on the application for new business. For example, applications for automobile insurance may be checked by requesting motor vehicle reports issued by a state department of motor vehicles. Applications for surety and large deductible policies may include a review of the financial stability of the insured. Applications for certain property coverages may require engineering surveys or fire hazard surveys. Often, companies will complete the underwriting process before a quote is released to the agent or broker. Companies may also perform an underwriting evaluation for certain renewals and endorsement transactions.

**3.10** If the quote is accepted, insurance coverage may be "bound," pending issuance of the policy. In these cases, the agent or broker may provide the insured with a *binder*, which is a temporary contract that may be oral or written. The period covered by the binder is usually short, often limited to 30 days or less. A written binder is evidence of an understanding by both parties of what the insurance covers, the amount of insurance, the premium charged, and the entity writing the insurance. Typically, once coverage is bound, the significant insurance terms are agreed upon by both parties, with minor contract terms finalized when the policy is issued.

**3.11** If the underwriter determines that the applicant falls within the entity's underwriting guidelines and is an acceptable risk, the underwriting approval is documented and the risk is coded so the entity can prepare reports concerning premiums such as the following:

- a. Premiums by state, line of business, and underwriting year, which are required to be included in the entity's annual statement or other regulatory filings
- b. Premiums written by territory and class of risk, which are required by the entity or rating bureaus to aid in ratemaking
- c. Premiums by producer, which are required to prepare agents' production reports and compute any contingent commissions due at the end of a year

**3.12** If an application is denied, the deposit premium is returned to the applicant with an explanation. When the refund is sent, the suspense account is cleared. In the case in which the entity does not require a deposit premium, the agent or broker is notified of the application being denied.

**3.13** Accounting entries are made for accepted applications by crediting premiums written, clearing the premium cash-suspense account for the deposits, and recording the balances due as agents' balances or premiums receivable. The combination of the rating codes entered into the policy processing system becomes the basis for the premium rates charged. Premiums are typically recorded when the policy is bound, as long as the relevant terms are agreed upon by both parties. Premiums are initially recorded as deferred revenue and then as premium earned. See the discussion on revenue recognition in [paragraphs 3.30-.49](#).

**3.14** Generally, a renewal of a policy is a new contract, but unless otherwise stated, the terms are those of the original policy. The risk insured under the original policy expires when the policy expires and each renewal must be considered as an application for a new risk. When a policy is renewed, the premium is determined in the same manner as for a new business policy.

**3.15** Finally, after a risk has been accepted and the premium has been calculated, a determination must be made about whether the entire risk should be retained or all or part of it should be reinsured. If

reinsurance is chosen, treaty or facultative reinsurance is purchased, or the reinsurance entity(s) on an existing agreement is notified, and the amount of ceded premium is determined and paid. In some cases, the availability of reinsurance is taken into consideration in deciding whether to write the direct business. Reinsurance is discussed in detail in [chapter 6](#) of this guide.

**3.16** Personal lines policies, applications, and endorsements may be submitted electronically (typically through the Internet or agency interface systems) or by paper. If submitted by paper, applications and endorsements are keyed into the policy processing system by customer service representatives. For commercial lines policies, an agent or a broker obtains the pertinent information from the customer and submits an application to the underwriting department for review. For personal lines policies, whether keyed into the system or interfaced electronically, information from the application or endorsement is reviewed by an underwriter or passed through automated underwriting criteria. Although some commercial lines policies may be passed through automated underwriting criteria, in most cases, applications for commercial lines policies are evaluated by an underwriter. For transactions that meet the entity's underwriting criteria, the policies are coded to the appropriate line of business. If policy transactions cannot be coded or processed automatically by the systems, they may be forwarded to a coding unit, which verifies data to the application or supplemental information received from the agent or insured. Once verified, manually coded applications and endorsements are then entered into the policy processing system. If not processed in real time, policy transactions may be batched and processed nightly. Typically, transactions entered into a policy processing system are interfaced with policy master files and statistical reporting systems at which point a policy number is assigned. This typically comprises an alphanumeric string, with the alpha prefix component of the policy identifier representing an abbreviated policy symbol designation of the type of coverage being provided. Companies should have controls to ensure that all processed transactions are balanced between the policy processing system and policy master file and statistical reporting systems. There should be controls that reconcile written premium and commissions processed in the policy processing system or policy master file to what is recorded in the billing systems. For personal lines policies, processing the information generates an insurance ID card as well as information such as terms of the policy, lines of coverage, premiums, and agent information. The policy, including any endorsements, is prepared, assigned a policy number, and sent directly to the insured or agent or broker for distribution. Underwriting files containing original documentation will be maintained at the branch or home office locations where underwriting was conducted.

### ***Billing and Collecting Premiums***

**3.17** The two basic methods for billing premiums are agency billing and direct billing. Some companies use only one of these methods; others use both. Under direct billing, the entity sends bills directly to the policyholders and the policyholders remit the premiums directly to the entity. Uncollected premiums from policyholders represent premiums due to the entity that may have been directly solicited from policyholders either by an agent or the company. Customers typically have the option of remitting premiums on an installment basis. Billing may be on a monthly, quarterly, annual, or other installment schedule. If an agent solicited the business, the entity, after receiving payments from the policyholders, either sends the agent a check or otherwise credits the agent's account for his or her commission.

**3.18** The following are several variations of agency billing, also called *account current*:

- *Account current item basis.* For individual policies, the agent collects the premiums directly from the insureds, subtracts his or her commissions, and remits the net premiums due the entity. If the agent cannot collect a premium during the credit period allowed by the entity, he or she may request

cancellation of the policy.

- *Account current rendering basis.* The agent submits a statement of all the policies issued or due during the current month to the insurance entity and the net amount of the statement is subsequently to be paid in accordance with the agency agreement. The statement, which includes all known current activity, such as endorsements, cancellations, and audits, is compared with the entity's accounts receivable and adjusted as necessary.
- *Account current billing basis.* The entity sends the agent a statement that contains a listing of all the policies written or due minus the policies cancelled during the month. The net amount of the statement is to be paid in accordance with the agency agreements.

**3.19** The credit terms to agents are usually outlined in the agency agreement. The agent's account current is usually payable within a specified period after the last day of the month of the account.

**3.20** Uncollected premiums from an agent represent premiums due the entity from the agent based on his or her contract with the entity to write insurance, collect the necessary premiums, and remit the collected premiums net of commissions. For balances due from agents, companies maintain a record or register of balances due and collected by policy. This register may include information by line of business, such as current premiums, commissions, year-to-date premiums, current expired, premiums in force, and earned and unearned premiums. The entity reconciles accounts current submitted by the agent with transactions as reflected in the entity's records. An agent's aged trial balance includes information such as the current month's premiums, net premiums, prior balance, cash received, net balance, installment fees, and balance due. In addition, the agent's trial balance is reviewed to determine any uncollectible accounts.

**3.21** The premium collection or remittance department is responsible for accounting for customer remittances and the agent's account current. Adequate control over these documents and the related cash must be maintained to ensure that all payments received are processed. Customers and agents may pay by check, electronic check, debit card, credit card, or wire transfer and may remit payment by Internet, phone, or mail. If customers send payment by mail, they are typically asked to send a preprinted remittance form along with the check. Many remittance processing systems can scan or read policy information from the remittance form electronically through technology such as imaging or optical character recognition. Some remittances must be keyed in manually. Customer and agent remittances should be batched, and the amount of cash deposited should be reconciled to the amount of cash applied to outstanding agents' balances and premiums receivable. Some companies may outsource these functions to a lockbox or other third-party service provider. Procedures should be in place to maintain unapplied collections in a suspense account and to clear items from the suspense account timely. Billing functions typically have customer service departments that perform a number of activities, including extending payment terms, collecting outstanding balances, and charging off uncollectible balances.

### ***Paying Commissions and Other Costs of Acquiring Business***

**3.22** Agents, both independent and exclusive, and brokers are compensated for their services by commissions. Some commissions are paid on the basis of a standard percentage of premiums or an agreed upon scale known as level commissions. Commission can be paid to agents either as the insurance entity receives payments or entirely upfront when the installment down payment is received. Retroactive commissions are used in areas such as workers' compensation in which the final premium may be experience rated and the commissions would therefore require adjustment. Contingent commissions result from agreements with agents and brokers whereby the amounts of commissions are

contingent on premium volume or favorable loss experience of the business placed with the entity. Establishing accounting provisions for contingent commissions is difficult because they are based on estimates of the ultimate loss experience, and in many cases, the commission period does not coincide with the entity's fiscal year. Readers should note that contingent commissions have been under regulatory scrutiny in recent years and understand what arrangements are acceptable. Insurance entities may also have other incentive compensation arrangements, such as an incentive paid to an agent's customer service representatives for each policy issued.

### ***Financial and Statistical Reporting***

**3.23** Typically, companies have frontend policy processing application systems that interface with a policy master file or system. This information is automatically carried over to the general ledger and statistical reporting systems. There should be balancing controls in place to ensure that transaction counts and amounts are in agreement when one application system updates another. Proper coding of premiums is important because it affects areas such as loss reserving; future underwriting and pricing decisions; ceding to treaty reinsurance; and the accrual of premium taxes, premium-based assessments, and contingent commission arrangements.

**3.24** Each state insurance department requires all insurance entities licensed to write business in that state to file an annual statement, also referred to as the convention blank, statutory blank, or simply the blank, with the state insurance commissioner for each individual insurance entity. The blank includes numerous schedules on premiums, including premiums written by the state. See [paragraph 1.74](#) of this guide for additional discussion of the annual statement.

**3.25** An entity should have appropriate controls to ensure that data file transfers from one system to another are complete and accurate, including job scheduling controls and balancing routines. An entity should also have data validation edits, required fields, and other application controls to check the completeness and accuracy of information entered by consumers or agents over the Internet or through agency interface systems. Appropriate change management controls should be in place to ensure that only authorized changes are made to key application systems.

**3.26** An entity should also have controls to protect data integrity in the physical environment, including, for example, making servers accessible only to network administrators and protecting hardware and storage media from power surges. In addition to controls over physical access, there should be controls over logical access, including passwords to access networks, databases, and application systems. An entity should also maintain current authorization levels for all users, document system administration procedures, and create disaster recovery plans for occurrences such as power outages, server failure, and virus attacks. There should also be appropriate protocols over data interchange at the hardware device level and application program level. Some of these protocols for the Internet include transmission control protocol, Internet protocol, hypertext transfer protocol, and file transfer protocol. An entity should also have appropriate security over data exchanged over the Internet, including, for example, the use of data encryption and firewalls. Logical access controls should be sufficient to protect nonpublic personal information of consumers, as required under the Gramm-Leach-Bliley Act of 1999.

### **Involuntary Markets**

**3.27** As discussed in [paragraph 1.08](#), states have established mechanisms to provide insurance to those with high risks who would otherwise be excluded from obtaining coverage. For property in high risk areas, Fair Access to Insurance Requirements (FAIR) Plans, which are federally approved and state supervised, provide insurance to owners. Companies that operate in a state are assessed for any underwriting loss experienced by the FAIR Plan in the state. Many insurers make flood insurance

available to their customers through the National Flood Insurance Program (NFIP) offered by the federal government. In 2012, Congress passed the Biggert Waters Flood Insurance Reform Act. Key provisions of the legislation will require the NFIP to raise rates to reflect true flood risk, make the program more financially stable, and change how flood insurance rate map updates impact policyholders. The changes will increase rates for certain policyholders. Some states, most notably Florida, have established catastrophe funds or state sponsored insurance companies to provide property coverage in high exposure locations where insurers are not willing to provide such coverage. In some cases, the fund or state sponsored insurance entity is authorized to assess a portion or all of the state's accumulated deficit if premiums are insufficient to cover losses and expenses. The Citizens Property Insurance Corporation in Florida is an example of this arrangement.

**3.28** Similar to FAIR Plans, states also provide workers' compensation insurance through workers' compensation pools. The most significant of these workers' compensation arrangements are the NCCI pools that operate in the great majority of states that do not have their own state specific workers' compensation involuntary arrangement. Companies operating in a given state are assigned a proportionate share of the pool's results based on direct writings of the underwriting results of the pool. States also provide medical malpractice insurance through medical malpractice pools. These pools were established by law and currently exist in the majority of states. All insurers writing related liability insurance in such states are considered mandatory participants in the pools as a condition for their continuing authority to transact business in such states. States also have several methods of apportioning involuntary automobile insurance. These methods include automobile insurance plans, joint underwriting associations, and reinsurance pools or associations. However, certain states allow the insurance entity the option to not participate in the involuntary pool and to write the high risk business on their own paper, which is called a direct assignment.

**3.29** Thus, involuntary mechanisms may be summarized as follows:

- Premiums assumed from an involuntary pool, such as NCCI, based on direct voluntary writings in the state.
- Premiums written directly as a "takeout" in lieu of an involuntary apportionment (that is, direct assignments).
- Assessments charged by a state that are recoupable as part of the premium or incorporated into the approved premium rate. These assessments may be based on voluntary premium writings or losses incurred in a given line(s) of business. Refer to [chapter 8](#) of this guide for a further discussion of assessments.
- Pass through surcharges imposed by a state or municipality. Such surcharges are usually specified as a percentage of premiums. The insurer records the collection and payments through the balance sheet only because it is functioning solely as a collections facility.

## Accounting for Premiums and Acquisition Cost <sup>1</sup>

<sup>1</sup> Readers should refer to the section " [Insurance Contracts Project](#) " in the preface of this guide. In July 2010, the International Accounting Standards Board (IASB) issued the exposure draft *Insurance Contracts*. On September 17, 2010, FASB issued, for public comment, the discussion paper *Preliminary Views on Insurance Contracts*.

On June 20, 2013, the IASB issued a revised exposure draft, *Insurance Contracts*, and on June 27, 2013, FASB issued an exposure draft, *Insurance Contracts*, both with comments due by October 25, 2013.

At the February 19, 2014 meeting, FASB tentatively decided to change the direction of the project to limit the scope to insurance entities as described in existing U.S. GAAP and only make targeted improvements to existing U.S. GAAP.

Readers should remain alert to any final pronouncements. **Premium Revenue and Premium Adjustments**

### ***Generally Accepted Accounting Principles***

**3.30** Under generally accepted accounting principles (GAAP), many specialized industry accounting principles for revenue recognition for property and liability insurance enterprises are specified in Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 944, Financial Services-Insurance*. Most property and liability insurance contracts are classified as short duration contracts, and this guide generally focuses on such contracts. In order for a contract to be accounted for using insurance accounting, the contract must provide for the indemnification of the insured against loss or liability, as noted in [FASBASC 720-20-25-1](#). GAAP accounting for insurance contracts that do not transfer insurance risk is discussed briefly in [paragraph 3.64](#) and in more detail in [chapter 6](#) of this guide.

**3.31** As noted in [FASB ASC 944-20-15-2](#), insurance contracts shall be classified as short- or long-duration contracts depending on whether the contracts are expected to remain in force for an extended period. As discussed in [FASB ASC 944-20-15-7](#), the factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period for a short-duration contract are as follows:

- a. The contract provides insurance protection for a fixed period of short duration
- b. The contract enables the insurer to cancel the contract or adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided

**3.32** Also discussed in [FASB ASC 944-20-15-10](#) are the factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period for a long-duration contract. These factors are as follows:

- a. The contract generally is not subject to unilateral changes in its provisions, such as a noncancellable or guaranteed renewable contract
- b. The contract requires the performance of various functions and services, including insurance protection, for an extended period

**3.33** A short duration contract is not necessarily synonymous with a term of one year or less. Examples exist of short duration contracts that extend beyond one year, such as multiyear retrospectively rated

policies, residential contractors' policies, surety policies that remain in force over the term of a project, and product warranty and residual value contracts that may extend over several years.

**3.34** As noted in [FASB ASC 944-605-25-1](#) , premiums from short duration contracts shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period or period of risk, if different, except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

**3.35** Under several types of contracts, the period of risk differs significantly from the contract period. An example is insurance for recreational vehicles issued for an annual period and covering claims that are incurred primarily in the summer months. Under other kinds of contracts, the amount of coverage declines over the contract period on a scheduled basis. An example is an insurance policy covering the residual value of a vehicle that is leased or financed. In those cases, the premium is recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

**3.36** As discussed in [FASB ASC 944-605-25-2](#) , if premiums are subject to adjustment (for example, retrospectively rated or other experience rated insurance contracts for which the premium is determined after the period of the contract based on claim experience, or reporting form contracts for which the premium is adjusted after the period of the contract based on the value of the insured property), premium revenue shall be recognized as follows:

- a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall be revised to reflect current experience.
- b. If the ultimate premium cannot be reasonably estimated, the cost recovery method or deposit method may be used until the ultimate premium becomes reasonably estimable.

**3.37** For retrospectively rated contracts, the additional premium or premium reduction determined after the period of the contract is based on current experience, as noted in [paragraph 3.36a](#) . Examples of variables affecting insurance premiums include the following:

- For retrospectively rated contracts, the premium is adjusted during and after the period based on the actual loss experience of the insurance contract.
- For reporting form contracts, the premium is adjusted after the period of the contract based on the value of insured property.
- For workers' compensation policies subject to audit premiums, the premium adjustment is based on a review of actual payroll during the policy period versus the estimated payroll that was used to determine the initial premiums.

**3.38** As defined in the FASB ASC glossary, under the cost recovery method, premiums are recognized as revenue in amounts equal to estimated claims as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until then. Also defined in the FASB ASC glossary, under the deposit method, premiums are not recognized as revenue, claims are not charged to

expense until the ultimate premium is reasonably estimable, and income recognition is postponed until that time.

**3.39** Readers should also be aware that a portion of the premium may be deferred because the billed premiums are for coverage to be provided by the insurance entity over the term of the policy. At the end of each reporting period, unearned premiums (premiums related to future insurance coverage to be provided during the contract term) are calculated, and the change in unearned premiums is recorded as a charge or credit to premium income. Consistent with the guidance in [FASB ASC 944-605-25-1](#) , [944-30-25-1](#) , and [944-30-45-1](#) , unearned premium is recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided.

**3.40** GAAP does not reflect written premiums in the income statement (see [paragraphs 3.41-.49](#) for statutory accounting), but disclosures are required, as discussed in [FASBASC 944-605-50-1\(b\)](#) . GAAP also does not have a similar requirement to statutory accounting to nonadmit a portion of receivables due for audit premiums, although a bad debt allowance should be provided for amounts deemed uncollectible.

### ***Statutory Accounting Principles***

**3.41** Paragraph 3 of Statement on Statutory Accounting Principles (SSAP) No. 53, *Property Casualty Contracts-Premiums*, notes that, except for workers' compensation contracts, written premium is defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract.

**3.42** Paragraph 4 of SSAP No. 53 also notes that

[f]or workers' compensation contracts, which have a premium that may periodically vary based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract, and written premium is recorded on the basis of that frequency.

**3.43** Written premiums do not affect the statement of income but are used as a means of tracking the amount of business written by type or location. As discussed in [paragraph 3.24](#) , the blank includes numerous schedules on premiums, including premiums written by state.

**3.44** Paragraph 6 of SSAP No. 53 states that

[w]ritten premiums for all other contracts shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired.

**3.45** Paragraph 7 of SSAP No. 53 also notes that

[t]he exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of contracts shall be recognized in the statement of income, as earned premium, using either the daily pro-rata or monthly pro-rat methods as described in paragraph 7 of SSAP No. 53.

**3.46** Paragraph 14 of SSAP No. 53 states that

[a]dvance premiums result when the policies have been processed, and the premiums have been paid prior to the effective date. These advance premiums are reported as a liability in the statutory financial statement and not considered income until due. Such amounts are not included in written premium or the unearned premium reserve.

**3.47** As discussed in paragraphs 10-13 of SSAP No. 53

[a]adjustments to the premium charged for changes in the level of exposure to insurance risk (e.g., audit premiums on workers' compensation policies) are generally determined based upon audits conducted after the policy has expired. Reporting entities shall estimate audit premium, which is generally referred to as earned but unbilled (EBUB) premium, and shall record the adjustment to premium either through written and earned premium or as only an adjustment to earned premium. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using historical entity unearned premium data, or per policy calculations.

EBUB shall be adjusted upon completion of the audit, with the adjustment recognized as revenue immediately. Upon completion of an audit that results in a return of premiums to the policyholder, earned premiums shall be reduced.

[r]eporting entities shall establish all of the requisite liabilities associated with the asset such as commissions and premium taxes. These liabilities shall be determined based on when premium is earned, not collected.<sup>2</sup>

[t]en percent of the EBUB asset in excess of collateral specifically held and identifiable on a per policy basis shall be reported as a non-admitted asset. To the extent that amounts in excess of 10% are not anticipated to be collected, they shall be written off in the period the determination is made.

<sup>2</sup> If an entity feels comfortable enough in their ability to collect the premium that an asset is recorded, they should also book the associated liabilities. Once an estimate of the premium has been made and the entity feels certain that it will be collected, it should also book the liabilities that will be due when they receive the cash. If the premiums are unearned and the policyholder had the ability to cancel, the definition of a liability has not been met. **3.48** As noted in paragraph 5 of SSAP No. 66, *Retrospectively Rated Contracts*, initial premiums from retrospectively rated contracts shall be recognized in accordance with SAP No. 53 or other SSAPs, depending on whether the contracts are life, property, casualty, or accident and health contracts. Also, as discussed in paragraph 8 of SSAP No. 66

[r]etrospective premium adjustments are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Additional retrospective premiums and return retrospective premiums shall be recorded as follows:

a. Property and Liability Reporting Entities:

- i. Accrued additional retrospective premiums shall be recorded as a receivable with a corresponding entry made to written and earned premiums or as only an adjustment to

earned premiums. Premium not recorded through written premium when accrued shall be recorded through written premium when billed.

ii. Accrued return retrospective premiums payable shall be recorded as a write-in liability with a corresponding entry made to written or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed.

iii. Ceded retrospective premium balances payable shall be recorded as liabilities, consistent with SSAP No. 62, *Property and Casualty Reinsurance*. Ceded retrospective premiums recoverable shall be recorded as an asset. Consistent with SSAP No. 64, *Offsetting and Netting of Assets and Liabilities*, ceded retrospective premium balances payable may be deducted from ceded retrospective premiums recoverable when a legal right of setoff exists.

**3.49** Paragraph 9 of SSAP No. 66 fully explains how to determine the amount of accrued estimated retrospective premiums to be recorded as a nonadmitted asset. If the retrospective premium receivable is due from an insured for whom any agent's balance or uncollected premiums are classified as nonadmitted, or the amounts are not billed in accordance with policy or contract provisions, then 100 percent of the asset shall be treated as nonadmitted. Similar to EBUB, 10 percent of accrued additional retrospective premiums in excess of collateral identifiable on a per policy basis shall also be reported as a nonadmitted asset.

## Premium Receivable

### ***Generally Accepted Accounting Principles***

**3.50** Uncollected premiums due from an agent, net of commissions payable, are generally reflected as agents' balances or uncollected premiums. Under direct billing, the entire amount of uncollected premiums recorded within agents' balances is generally referred to as uncollected premiums. Commissions due to agents on premiums billed directly to the insured are recorded as a liability. Some insurance companies issue bill receivables, which are generally interest bearing and used as a method of financing premiums. These amounts are also included in agents' balances. Companies should consider FASBASC 210-10. The FASB ASC glossary defines *right of setoff* and **FASB ASC 210-10-45-1** specifies what conditions must be met to have that right.

**3.51** Under **FASB ASC 310-10-35**, *Receivables*, and FASB ASC 450, *Contingencies*, an allowance should be recorded for the amount of the receivable that is deemed uncollectible. The allowance is recorded as a contra-asset to the agents' balances and premium receivable account. The expense is generally recorded as bad debt expense in the income statement.

**3.52** Under GAAP, **FASB ASC 450-20-50-3** similarly notes that disclosure of the contingency shall be made when at least a reasonable possibility exists that a loss or an additional loss may have been incurred, and either of the following conditions exists:

- a. An accrual is not made for a loss contingency because any of the conditions in **FASB ASC 450-20-25-2** are not met
- b. An exposure to loss exists in excess of the amount accrued pursuant to the provisions of **FASB**

**ASC 450-20-30-1****Statutory Accounting Principles**

**3.53** Paragraph 7 of SSAP No. 6, *Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*, states that

[t]he due date for all premium balances addressed by this statement is determined as follows:

- a. Original and deposit premiums-governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship;
- b. Endorsement premiums-governed by the effective date of the insurance policy endorsement;
- c. Installment premiums-governed by the contractual due date of the installment from the insured;
- d. Audit premiums and retrospective premiums-governed by insurance policy or insurance contract provisions. If the due date for receivables relating to these policies is not addressed by insurance policy provisions or insurance contract provisions, any uncollected audit premium (either accrued or billed) is nonadmitted.

**3.54** Paragraph 9 of SSAP No. 6 states that

[n]onadmitted assets are determined:

- a. **Uncollected Premium**-To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days shall be nonadmitted. If an installment premium is over ninety days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be nonadmitted;
- b. **Bills Receivable**-Bills receivable shall be nonadmitted if either of the following conditions are present:
  - i. If any installment is past due, the entire bills receivable balance from that policy is nonadmitted; or
  - ii. If the bills receivable balance due exceeds the unearned premium on the policy for which the note was accepted, the amount in excess of the unearned premium is nonadmitted.
- c. **Agents' Balances**-The uncollected agent's receivable on a policy by policy basis which is over ninety days shall be nonadmitted regardless of any unearned premiums;
  - i. If amounts are both payable to and receivable from an agent on the same underlying policy, and the contractual agreements between the agent and the reporting entity permit offsetting, the nonadmitted portion of amounts due from that agent shall not be greater than the net balance

due, by agent;

ii. If reconciling items between a reporting entity's account and an agent's account are over ninety days due, the amounts shall be nonadmitted.

**3.55** As outlined in paragraph 10 of SSAP No. 6

[a]fter calculation of non-admitted amounts, an evaluation shall be made of the remaining admitted assets in accordance with SSAP No. 5, *Liabilities, Contingencies, and Impairments of Assets*, to determine if there is impairment. If, in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in SSAP No. 5 shall be followed.

## Acquisition Costs

### **Generally Accepted Accounting Principles**

**3.56** Under GAAP, FASB Accounting Standards Update (ASU) No. 2010-26, *Financial Services-Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*, which was codified into FASB ASC 944-30, states that only acquisition costs that are directly related to the successful acquisition of a contract can be capitalized as deferred acquisition costs (DAC). As noted in ASU No. 2010-26, if the initial application of the amendments in ASU No. 2010-26 results in the capitalization of acquisition costs that had not been capitalized previously by an entity, the entity may elect not to capitalize those types of costs.<sup>3</sup> These deferred amounts are recorded as an asset on the balance sheet and amortized to income in a systematic manner based on related contract revenues. Previously, the guidance of FASB ASC 944-30 did not address successful versus unsuccessful efforts.

<sup>3</sup> A number of property and liability insurance entities have historically limited their deferral of acquisition costs to only commissions and premium-based taxes. As noted in [paragraph 3.56](#), at the initial implementation date of Financial Accounting Standards Board (FASB) Accounting Standards Update No. 2010-26, *Financial Services-Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*, an entity may elect not to capitalize costs that were not capitalized previously. **3.57** *Determination of deferrable costs*. The FASB ASC glossary defines acquisition costs as costs that are related directly to the successful acquisition of new or renewal insurance contracts.

**3.58** As discussed in [FASB ASC 944-30-25-1A](#), an insurance entity shall capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:

- a. Incremental direct costs of contract acquisition
- b. The portion of the employee's total compensation, excluding any compensation that is capitalized as incremental direct costs of contract acquisition, and payroll related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has

been acquired:

- i. Underwriting
  - ii. Policy issuance and processing
  - iii. Medical and inspection
  - iv. Sales force contract selling
- c. Other costs related directly to the insurer's acquisition activities in (b) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred
- d. Advertising costs that meet the capitalization criteria in **FASB ASC 340-20-25-4**

**3.59** *Incremental direct costs of contract acquisition.* The FASB ASC 944-30 glossary defines incremental direct costs of contract acquisition as a cost to acquire an insurance contract that has both of the following characteristics:

- a. It results directly from, and is essential to, the contract transaction(s)
- b. It would not have been incurred by the insurance entity had the contract transaction(s) not occurred

**3.60** **FASB ASC 944-30-55-1** discusses the types of incremental direct cost of contract acquisition to be capitalized under item (a) **FASB ASC 944-30-25-1A**. Such costs include the following:

- a. An agent or broker commission or bonus for successful contract acquisition(s)
- b. Medical and inspection fees for successful contract acquisition(s)

**3.61** *Total compensation, benefits, and other costs directly related to acquisition activities.* Items (b)-(c) of **FASB ASC 944-30-25-1A** requires that only the portion of costs related directly to time spent performing specified acquisition activities for a contract that actually has been acquired (that is, successful efforts) may be deferred.

**3.62** **FASB ASC 944-30-55-1C** discusses that payroll related fringe benefits include any costs incurred for employees as part of the total compensation and benefits program. Examples of such benefits include all of the following:

- a. Payroll taxes
- b. Dental and medical insurance
- c. Group life insurance
- d. Retirement plans
- e. 401(k) plans

- f. Stock compensation plans, such as stock options and stock appreciation rights
- g. Overtime meal allowances

**3.63 FASB ASC 944-30-55-1G** discusses that the portion of total compensation of executive employees that relates directly to the time spent approving successful contracts may be deferred as acquisition costs. For example, the amount of compensation allocable to time spent by members of a contract approval committee is a component of acquisition costs.

**3.64 FASB ASC 944-30-55-1A** discusses that examples of other costs related directly to the insurer's acquisition activities in item (b) of **FASB ASC 944-30-25-1A** that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred include all of the following:

- a. Reimbursement of costs for air travel, hotel accommodations, automobile mileage, and similar costs incurred by personnel relating to the specified activities
- b. Costs of itemized long distance telephone calls related to contract underwriting
- c. Reimbursement for mileage and tolls to personnel involved in onsite reviews of individuals before the contract is executed

**3.65 Direct response advertising.** **FASB ASC 340-20-25-4** notes that the costs of direct response advertising should be capitalized if both of the following conditions are met:

- a. The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising
- b. The direct response advertising results in probable future benefits

**3.66 FASB ASC 340-20-25-6** specifies that in order to conclude that advertising elicits sales to customers who could be shown to have responded specifically to the advertising, there must be a means of documenting that response, including a record that can identify the name of the customer and the advertising that elicited the direct response. Examples of such documentation include the following:

- a. Files indicating the customer names and related direct response advertisement
- b. A coded order form, coupon, or response card included with an advertisement indicating the customer name
- c. A log of customers who have made phone calls to a number appearing in an advertisement, linking those calls to the advertisement

**3.67** Additional guidance for issuers to consider can be found in section 1(B), "Accounting for Advertising Costs," of the Securities and Exchange Commission's *Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*:

Certain direct response advertising costs may be deferred under [ **FASB ASC 340-20-25** ]. Qualifying costs relating to a specific advertising activity must meet all of the following criteria:

- (a) A direct relationship between a sale and the specific advertising activity for which cost is deferred must be demonstrated clearly. More than trivial marketing effort after customer response to the advertising and before the sale is consummated (such as customer contact with a sales person or furnishing of additional product or financing information) will disqualify the sale as being deemed a direct result of the advertising. A significant lapse of time between the advertising activity and the ultimate sale in an environment of broad general advertising may disqualify the sale as being deemed a direct result of the advertising.
- (b) The advertisement's purpose must be one of eliciting a direct response in the form of a sale. For example, if the primary purpose (based on either intent or most frequent actual outcome) is identification of customers to which additional marketing efforts will be targeted, the advertising costs do not qualify.
- (c) Deferrable costs do not include administrative costs, occupancy costs, or depreciation of assets other than those used directly in advertising activities. Payroll related costs that are deferrable include only that portion of employees' total compensation and payroll-related fringe benefits that can be shown to directly relate to time spent performing the qualifying activities. Costs of prizes, gifts, membership kits and similar items are not deferrable under [ **FASB ASC 340-20-25** ], but are accounted for as inventory in most circumstances.
- (d) The costs must be probable of recovery from future benefits. Objective historical evidence directly relevant to the particular advertising activity is necessary to demonstrate probability of recoverability. Ancillary income from sources other than the responding customer may not be included in the calculation of future benefits for the test. Future benefits to be included in the calculation are limited to revenues derived from the customer which are the direct result of the advertising activity alone, without significant additional marketing effort. Revenues from subsequent sales and renewals may be included only if insignificant market effort is required to obtain those revenues.

**3.68** If the capitalization criteria in **FASB ASC 340-20-25-4** are met, the direct response advertising costs should be included as DAC for classification, subsequent measurement, and premium deficiency test purposes in accordance with FASB ASC 944 applicable to insurance industry DAC.

**3.69** As noted in **FASB ASC 340-20-25-12** , the cost of the direct response advertising directed to all prospective customers, not only the cost related to the portion of the potential customers that are expected to respond to the advertising, should be used to measure the amounts of such reported assets.

**3.70** As noted in **FASB ASC 340-20-25-8** , the probable future benefits of direct response advertising activities are probable future revenues arising from that advertising in excess of future costs to be incurred in realizing those revenues. **FASB ASC 340-20-25-9** discusses that demonstrating that direct response advertising will result in future benefits requires persuasive evidence that its effects will be similar to the effects of responses to past direct response advertising activities of the entity that resulted in future benefits. Such evidence should include verifiable historical patterns of results for the entity.

Attributes to consider in determining whether the responses will be similar include the following:

- a. The demographics of the audience
- b. The method of advertising
- c. The product
- d. The economic conditions

**3.71** *Nondeferrable expenses.* As stated in **FASB ASC 944-720-25-2** , an insurance entity should charge to expense as incurred any of the following costs:

- a. An acquisition related cost that cannot be capitalized in accordance with **FASB ASC 944-30-25-1A** (for implementation guidance, see **FASB ASC 944-720-55-1** )
- b. An indirect cost (for implementation guidance, see **FASB ASC 944-720-55-2** )

**3.72** **FASB ASC 944-720-55-1** includes the following examples of acquisition related costs that cannot be capitalized in accordance with **FASB ASC 944-30-25-1A** :

- a. Soliciting potential customers (except direct response advertising capitalized in accordance with item (d) of **FASB ASC 944-30-25-1A** )
- b. Market research
- c. Training
- d. Administration
- e. Unsuccessful acquisition or renewal efforts (except direct response advertising capitalized in accordance with item (d) of **FASB ASC 944-30-25-1A** )
- f. Product development

**3.73** As discussed in **FASB ASC 944-30-55-1F** , employees' compensation and fringe benefits related to the activities described in **paragraph 3.72** , unsuccessful contract acquisition efforts, and idle time should be charged to expense as incurred.

**3.74** **FASB ASC 944-720-55-2** includes the following examples of indirect costs, per item (b) of **FASB ASC 944-720-25-2** , that should be expensed as incurred:

- a. Administrative costs
- b. Rent
- c. Depreciation

- d. Occupancy costs
- e. Equipment costs, including data processing equipment dedicated to acquiring insurance contracts
- f. Other general overhead

**3.75 FASB ASC 944-30-55-1B** notes that costs for software dedicated to contract acquisition are not eligible for deferral as DAC under the definition of that term. Under the definition of that term, such costs are not other costs related to those activities that would not have been incurred but for that contract. Notwithstanding that the guidance, as described in [paragraph 3.74](#), that indicates that equipment costs are expensed as incurred, insurance entities should consider the criteria in FASB ASC 350-40 to determine if the costs qualify for capitalization as internal use software.

**3.76 Cost determination.** The identification of acquisition costs requires considerable judgment, such as how to determine successful versus unsuccessful efforts and how to determine what types of activities performed by employees are considered to be directly related to sales. The determination of the costs to be deferred can often be determined separately or via a standard costing technique or through a combination of both. FASB ASC 944-30-55-1D-1E provides additional discussion.

**3.77 Allocation of DAC.** **FASB ASC 944-30-25-1B** requires the following:

To associate acquisition costs with related premium revenue, capitalized acquisition costs shall be allocated by groupings of insurance contracts consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts.

**3.78 Determining deferrable acquisition costs.** **FASB ASC 944-30-25-1A** (see [paragraph 3.58](#)) discusses what types of costs an insurance entity should capitalize as acquisition costs. An insurance entity should evaluate whether employee compensation and payroll related fringe benefits are related directly to time spent performing acquisition activities for contracts that actually have been acquired. This determination may be accomplished by a two-step process:

- a. Determine the portion of the employee's time spent performing acquisition activities
- b. Determine the portion of the employee's time spent in acquisition activities directly related to contracts that have been acquired (that is, successful efforts)

**3.79** Both of the following examples are meant to be illustrative and the actual determination of DAC under FASB ASC 944 should be based on the facts and circumstances of an entity's specific situation:

Example 1: In 201X, an employee of an insurance entity whose responsibility is sales force contract selling is compensated solely on a commission basis, based on the volume of business sold directly by the employee. The employee's current year commission of \$125,000 is calculated as a percentage of premiums relating to business sold directly by the employee in the current year. In this fact pattern, the \$125,000 commission is an incremental direct cost of contract acquisition, and the entire \$125,000 would be deferrable by the insurance entity.

Example 2: In 201X, an employee of an insurance entity earned a salary and payroll related fringe benefits of \$120,000 and spent approximately 80 percent of his or her time on qualifying acquisition activities, as described in [paragraph 3.58](#). Approximately 50 percent of this time resulted in successful contract acquisitions. The amount of costs that would be deferrable as acquisition costs would be \$48,000 ( $\$120,000 \times 80\%$  qualifying acquisition activities  $\times 50\%$  successful efforts).

**3.80** In situations when an employee is compensated by both commission and salary, judgment will be needed to determine what costs can be capitalized as acquisition costs (as discussed in [paragraph 3.58](#)), based on the facts and circumstances of each specific situation.

**3.81** [FASB ASC 944-605-25-14](#) discusses accounting for contingent commission arrangements and states that if retrospective commission or experience refund arrangements exist under experience rated insurance contracts, a separate liability shall be accrued for those amounts. Income in any period shall not include any amounts that are expected to be paid to agents or others in the form of experience refunds or additional commissions. Contingent commission receivable or payable shall be accrued over the period in which related income is recognized.

### ***Accounting for DAC in Connection With Modifications or Exchanges of Insurance Contracts***

**3.82** [FASB ASC 944-30-35](#) and [944-30-40](#) provide specific guidance on accounting for DAC on internal replacements and modifications of insurance and investment contracts. The AICPA also issued a series of Technical Questions and Answers (TISs) on accounting and financial reporting issues related to [FASB ASC 944-30-35](#) and [944-30-40](#) ([TIS sections 6300.25-.35](#) [AICPA, *Technical Practice Aids*]). Readers should be aware that [FASB ASC 944-30-35](#) and [944-30-40](#) apply to property and liability contracts.

### ***Statutory Accounting Principles***

**3.83** Under SSAP No. 71, *Policy Acquisition Costs and Commissions*, acquisition costs are expensed as incurred (see [chapter 6](#) of this guide for a discussion of the treatment of excess ceding commission under SSAP No. 62R). Refer to SSAP No. 66 for additional statutory accounting principles (SAP) guidance on accounting for contingent commissions.

### **Premium Deficiencies**

**3.84** A premium deficiency relating to short duration insurance contracts indicates a probable loss on premiums yet to be earned. [FASB ASC 944-60-25-4](#) states that a premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs<sup>4</sup> exceeds related unearned premiums.

<sup>4</sup> Per the FASB *Accounting Standards Codification* glossary, *maintenance costs* are defined as costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions. **3.85** As discussed in [FASB ASC 944-60-25-3](#), insurance contracts shall be grouped consistently with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists. [FASB ASC 944-60-25-5](#) states that a premium deficiency shall first be recognized by charging unamortized acquisition costs to expense to the extent required to eliminate the deficiency. As noted in [FASB ASC 944-60-25-6](#), if the

premium deficiency is greater than unamortized acquisition costs, a liability shall be accrued for the excess deficiency.

**3.86** Under SAP, SSAP No. 53 incorporates the same basic premise for determining a premium deficiency reserve but notes the following in paragraph 16:

Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings.

**3.87** **FASB ASC 944-60-50-1** states that an insurance entity should disclose in its financial statements whether it considers anticipated investment income in determining if a premium deficiency relating to short duration contracts exists. If an entity chooses to include anticipated investment income in the premium deficiency test, which is a policy choice, no authoritative guidance exists on how to calculate the anticipated investment income. As a result, varying industry practices exist. Over the years there has been discussion within the insurance community about whether any methods are more appropriate, but there has not been any authoritative guidance issued on this topic. There are two primary methods used in practice—the expected investment income approach, which computes anticipated investment income on the cash flows generated by current in force contracts, or the discounting approach, which discounts expected future payments for claim costs, claim adjustment expenses, and maintenance costs. Both methods incorporate the time value of money. Several variations exist within the expected investment income and discounting approaches. An entity's determination of how it performs premium deficiency testing would be a policy decision that should be applied consistently and based on individual facts and circumstances. If an entity chooses to change how it performs premium deficiency testing, it would be required to apply the guidance in FASB ASC 250, *Accounting Changes and Error Corrections*.

**3.88** Under the expected investment income approach, investment income is calculated on the total funds that are available from the contract for investment. Cash available for investment is determined by considering all cash flows from in force policies, including premiums, commissions, and other underwriting costs; premium taxes; claims and claim adjustment expenses; investment income; and expenses on both the unexpired and expired portions of in force policies. Under one variation of this approach, investment income is determined using cash flows associated with only the unexpired portion of the in force premium (that is, unearned premium less unamortized DAC). Generally, a premium deficiency would exist under this method if the sum of the future expected ultimate losses and expenses are greater than the unearned premium liability minus unamortized DAC plus investment income.

**3.89** Several variations exist under this approach in dealing with situations in which the fund goes negative. Under one approach, negative investment income would be included in the calculation, in effect imputing borrowing costs to the entity for the net cash outflows required to pay claims. An alternative approach would record only positive investment income but would not assess negative investment income when the fund is depleted. Instead, this method implicitly assumes that funds are available from surplus to cover any shortfalls. This rationale stems from the statutory notion that invested assets are expected to be maintained to support insurance liabilities.

**3.90** Under the discounting approach, a premium deficiency test considers the present value of future costs (consisting of claims, claim adjustment expenses, and maintenance expenses) expected to be incurred during the remaining portion of the contract plus unamortized acquisition costs. A premium deficiency would exist when such costs exceed the related unearned premiums. A variation of this

approach would consider the present value of future costs incurred and expected to be incurred on in force policies less liabilities recorded at the measurement date (both unearned premiums and any existing claim liability) plus related unamortized acquisition costs. This latter approach gives accounting recognition to the time value of money associated with both the expired and unexpired portions of the policies. By discounting all cash outflows at the anticipated investment yield rate, the discounting approach, like one version of the expected investment income approach noted previously, implicitly assumes that funds are available from surplus to cover all claim payments.

**3.91** The examples of premium deficiency calculations in [paragraph 3.97](#) show several variations of both the expected investment income and discounting approaches that are illustrative and not meant to include current actuarial assumptions.

**3.92** In the situation in which companies elect not to include the time value of money in the premium deficiency calculation, they would use the same components described in [FASB ASC 944-60-25](#) and SSAP No. 53, using nominal values for cash flows. For liabilities discounted under current GAAP and SAP guidance, such as workers' compensation tabular reserves or structured settlements, inclusion of the time value of money would be required in the premium deficiency calculation as well. The examples in this guide assume that the entity has elected to consider anticipated investment income in its premium deficiency test.

**3.93** When estimating the expected cash flow used in the premium deficiency test, although companies should consider their historical experience as an indicator of future cash flows, assumptions used in the calculated premium deficiency should be adjusted to reflect more recent or expected trends. The loss and loss expense ratio used to project anticipated losses can also be adjusted for items such as expected differences in rate adequacy and loss frequency and severity.

**3.94** In addition, if current year reported loss and loss expense ratios are used to project anticipated losses, the entity should exclude from the ratios the impact of reserve development on prior accident years, as well as large or unusual current accident year events. [FASB ASC 944-60-25](#) does not provide explicit guidance on whether to include estimates in the premium deficiency calculation for losses relating to actual events occurring subsequent to the balance sheet date. In practice, this is accounted for in multiple ways, with the common starting point being that the event is probable of occurring at the balance sheet date. One method is to include estimates for losses occurring subsequent to the balance sheet date, using all available information up through the date that the financial statements are issued. Another method is to include estimates for losses if the extent of the damage is reasonably estimable at the balance sheet date, using only information that theoretically existed at the balance sheet date. The Financial Reporting Executive Committee believes that an entity's determination of how to account for losses relating to actual events occurring subsequent to the balance sheet date within the premium deficiency calculation would be a policy decision that should be applied consistently and disclosed as follows:

- a. Probable at the balance sheet date, using all available information up through the date that the financial statements are issued. Estimates should be based on the entity's expectation of the future loss events that are probable at the balance sheet date, using all available information up through the date that the financial statements are issued. However, the estimates should not include losses relating to actual events occurring subsequent to the balance sheet date that were not probable at the balance sheet date. Therefore, estimates for infrequent, high severity events that are included in expected loss and loss expense ratios based on historical events and trends expected to continue should be included, but the expected cash flows should not include actual events, such as hurricanes or ice storms, that occur subsequent to the balance sheet date and that were not probable of occurring at the balance sheet date. However, in those rare circumstances when an infrequent, high

severity event is probable at the balance sheet date and expected to occur in the near future, expected losses relating to that probable event should be included in the premium deficiency calculation. For example, potential losses from a hurricane sitting off the coast of Florida at period end that hits the coast and causes damage shortly thereafter in the subsequent accounting period would rarely meet the criteria of being probable. In those instances, when the hurricane did hit, expected cash flows relating to the hurricane would be included in the premium deficiency calculation, using all available information up through the date that the financial statements are issued.

*b.* Probable and reasonably estimable at the balance sheet date, using only information that theoretically existed at the balance sheet date. Estimates should be based on the entity's expectation of future loss events that are probable and reasonably estimable at the balance sheet date, using only information that theoretically existed at the balance sheet date. However, the estimates should not include losses relating to actual events occurring subsequent to the balance sheet date that were not probable and reasonably estimable at the balance sheet date. Therefore, estimates for infrequent, high severity events that are included in expected loss and loss expense ratios based on historical events and trends expected to continue should be included, but expected cash flows should not include actual events, such as hurricanes or ice storms, that occur subsequent to the balance sheet date that were not both probable of occurring and reasonably estimable at the balance sheet date. The estimate should only be based on information that theoretically existed at the balance sheet date but not thereafter. In general, it would be very rare to have a situation that would meet both criteria of being probable of occurring and being able to reasonably estimate the extent of the damage, using information that theoretically existed at the balance sheet date. For example, potential losses from a hurricane sitting off the coast of Florida at period end that hits the coast and causes damage shortly thereafter in the subsequent accounting period would very rarely meet the criteria of being both probable and reasonably estimable, using information that theoretically existed at the balance sheet date. As a result, the hurricane would not be included in a premium deficiency calculation.

**3.95** In selecting the interest rate to be used under the expected investment income approach or the discount rate under the discounting approach, companies typically use a rate equal to the yield expected to be earned on total invested assets (expected portfolio rate) over the period that the claim liabilities are expected to be paid. This yield is the ratio of expected interest income; dividends; and rents, net of investment expenses, to the total invested assets. At each date that the calculation is performed, this yield would be adjusted for current market information.

**3.96** Care should be taken when calculating the premium deficiency for a line of business in cases in which an estimated loss ratio is used, and the liabilities for claims and claim adjustment expenses are already recorded at a discounted amount. To avoid double counting of anticipated investment income, the projected loss ratio used in the calculation should be adjusted to exclude the effect of any discount recorded under GAAP or SAP, so that the discount rates used to calculate anticipated investment income are applied to the estimated gross unpaid loss and loss adjustment expenses.

**3.97** Short duration PDR calculation examples that follow:

- No premium deficiency
  - - **Example 1A**, "Expected Investment Income Approach Using All Cash Flows From In Force Policies"

- - **Example 1B** , " Expected Investment Income Approach Using Only the Unexpired Portion of the Contract"
- - **Example 1C** , " Discounting Approach Using Only the Unexpired Portion of the Contract"
- Expected premium deficiency
  - - **Example 2A** , " Expected Investment Income Approach Using All Cash Flows From In Force Policies"
  - - **Example 2B** , " Expected Investment Income Approach Using Only the Unexpired Portion of the Contract"
  - - **Example 2C** , " Discounting Approach Using Only the Unexpired Portion of the Contract"

### **Background**

- Computation made as of December 31, 2011. All in force contracts have a policy term of one year or less.
- Earned premium on in force contracts as of December 31, 2011, is \$182,000. Unearned premiums as of December 31, 2011, are \$168,000, resulting in total in force premium of \$350,000.
- The block of in force contracts is expected to experience a 78 percent loss and loss expense ratio on the earned premium.
- The underwriting expenses incurred were 30.16 percent of premiums written, producing a combined ratio of 108.16 percent.
- Acquisition costs amount to 25 percent of premiums written. The difference between the incurred ratio of 30.16 percent and the deferral ratio of 25 percent is expensed currently as period costs.
- Maintenance costs are \$2,919 and are paid in the same pattern as claims (for simplicity).
- The payment pattern of the anticipated claims is derived using payment data from schedule P in the statutory annual statement.
- No policyholder dividends exist on these types of policies.

### **Example 1A**

#### **Expected Investment Income Approach Using All Cash Flows From In Force Policies**

Under the expected investment income approach, the entity projects the expected claim and claim expenses and the payment pattern of those costs. The expected claim and claim adjustment expenses typically include the recorded incurred losses related to the earned premium plus losses estimated by multiplying the expected loss and loss expense ratio by unearned premium for losses that have not been incurred.

Using the expected payment pattern and making certain assumptions concerning interest rates and the timing of premium collections, underwriting, and maintenance expense payments, the future investment income related to this block of in force premiums is computed.

#### **Anticipated Experience on Group of In Force Policies**

**(Example 1A-Exhibit 1)**

	<u><i>Earned on Unexpired</i></u>	<u><i>Unearned</i></u>	<u><i>In Force</i></u>
Premium	\$182,000	\$168,000	\$350,000
Actual loss and loss expense ratio	78%	-	-
Expected loss and loss expense ratio	-	<u>78%</u>	-
	<u><b>\$141,960</b></u>	<u><b>\$131,040</b></u>	<u><b>\$273,000</b></u>

***Assumptions***

- Analysis of individual entity experience indicates that the expected loss and loss expense ratio will be 78 percent on the in force block of business.
- The earned premium on unexpired policies was earned in 2011, and the related incurred loss and loss expense on earned premium is estimated to be \$141,960.
- The unearned premium of \$168,000 will be earned in 2012.
- The expected loss and loss expense on the unearned premium is \$131,040.

Based on historical claim payment patterns, the entity assumes that loss and loss expenses related to both the 2011 and 2012 accident years will be paid out as follows:

**Loss and Loss Expense Payments as a Percentage of Total Incurred Losses  
(Example 1A-Exhibit 2)**

<u><i>Payment Year</i></u>	<u><i>Percentage of Total Incurred Paid</i></u>
Calendar year of accident year	32.0
Accident year +1	28.0
Accident year +2	15.0
Accident year +3	12.0
Accident year +4	8.0
Accident year +5	5.0
	<u><b>100%</b></u>

These percentages are used in the [exhibit 3](#) .

**Settlement Pattern of Claims Related To In Force Policies  
(Example 1A-Exhibit 3)**

<i>Payment Year</i>	<u><i>Claims Related to 2011 Earned Premium</i></u>		<u><i>Claims Related to 2012 Earned Premium</i></u>		<u><i>Claims Related in Force Premium</i></u>	
	<i>%</i>	<i>\$</i>	<i>%</i>	<i>\$</i>	<i>%</i>	<i>\$</i>
2011	32.0	45,427	-	-	16.6	45,427
2012	28.0	39,749	32.0	41,933	29.9	81,682
2013	15.0	21,294	28.0	36,691	21.2	57,985
2014	12.0	17,035	15.0	19,656	13.4	36,691
2015	8.0	11,357	12.0	15,725	9.9	27,082
2016	5.0	7,098	8.0	10,483	6.5	17,581
2017	-	-	5.0	6,552	2.5	6,552
	<b><u>100.0</u></b>	<b><u>141,960</u></b>	<b><u>100.0</u></b>	<b><u>131,040</u></b>	<b><u>100.0</u></b>	<b><u>273,000</u></b>

***Explanation***

This exhibit shows the computation of the in force payment pattern using accident year data. When in force payment data is available, it should be used. The payment data is used in the computation of investment income in the following [exhibit 4](#).

**Computation of Anticipated Investments Income  
(Example 1A-Exhibit 4)**

<i>Year</i>	<u><i>Cash Opening Balance</i></u>	<u><i>Premiums Received</i></u>	<u><i>Underwriti ng Costs Paid</i></u>	<i>Claims</i>	<u><i>Maintenan ce Costs</i></u>	<u><i>Cash Ending Balance Before Investmen t Income</i></u>	<u><i>Cash Average Balance</i></u>	<u><i>Investmen t Income</i></u>
2011	\$-	\$350,000	30.16%	\$(45,427)	0.83%	\$- \$198,992	\$99,496	\$6,965
2012	205,957	-	-	(81,682)	(1,046)	123,229	164,593	11,522
2013	134,751	-	-	(57,985)	(742)	76,024	105,388	7,377

2014	83,401	-	-	(36,691)	(469)	46,241	64,821	4,537
2015	50,778	-	-	(27,082)	(347)	23,349	37,064	2,594
2016	25,943	-	-	(17,581)	(228)	8,134	17,038	1,193
2017	9,327	-	-	<u>(6,552)</u>	<u>(87)</u>	<u>2,688</u>	<u>6,008</u>	<u>421</u>
				<b><u>\$350,000</u></b>	<b><u>\$(105,581)</u></b>	<b><u>\$(273,000)</u></b>	<b><u>\$(2,919)</u></b>	<b><u>\$34,609</u></b>

Total expected investment income for future years (2012-17) **\$27,644**

**Assumptions for Computation of Anticipated Investment Income**

- Insurance contracts are issued, premiums are collected evenly throughout the year, and underwriting costs are incurred and paid as premiums are collected.
- Claims are paid evenly throughout the year.
- Maintenance costs are 0.83 percent of premiums and paid in the same pattern as claims for years after the contract term because it is the cost to maintain the contract.
- Investment income is earned on average assets and reinvested (interest rate multiplied by the average balance).
- The historical yield is 5.5 percent; however, the expected yield, which gives consideration to the historical yield, net cash invested at new money rates, and anticipated reinvestment rates, is 7.0 percent (investment portfolio yield).
- As stated in the "Background" section of these examples, underwriting costs are 30.16 percent of written premium.

**Premium Deficiency Test Using Expected Investment Income Approach as of December 31, 2011 (Example 1A-Exhibit 5) (Profitable Contracts)**

Unearned premiums at December 31, 2011 ( <a href="#">example 1A-exhibit 1</a> )	\$168,000
Less expected costs (undiscounted):	
Claims and claim adjustment expenses ( <a href="#">example 1A-exhibit 1</a> )	\$131,040
Maintenance costs ( <a href="#">example 1A-exhibit 4</a> )	2,919
Unamortized policy acquisition costs (25% of unearned premiums)	<u>42,000</u>

<i>Subtotal</i>	<u>\$175,959</u>
Premium deficiency before expected investment income	(7,959)
Anticipated investment income ( <b>example 1A-exhibit 4</b> )	<u>27,644</u>
Excess of income over costs	<u>\$19,685</u>

The premium deficiency test performed using the expected investment income approach indicates an excess. Therefore, no provision for premium deficiency would be made as of December 31, 2011.

**Example 1B**

**Expected Investment Income Approach Using Only the Unexpired Portion of the Contract)**

Under this variation of the expected investment income approach, investment income is determined only on the cash flows associated with the unexpired portion of the in force premium and claims related to 2012 earned premiums.

**Computation of Anticipated Investments Income Using Cash Flows Associated Only With the Unexpired Portion of the In Force Premium (Example 1B-Exhibit 1)**

<u>Year</u>	<u>Cash</u> <u>Opening</u> <u>Balance</u>	<u>Premiums</u> <u>Received</u>	<u>Underwrit</u> <u>ing Costs</u> <u>Paid</u>	<u>Claims</u>	<u>Maintenan</u> <u>ce Costs</u>	<u>Cash</u> <u>Ending</u> <u>Balance</u> <u>Before</u> <u>Investmen</u> <u>t Income</u>	<u>Cash</u> <u>Average</u> <u>Balance</u>	<u>Investmen</u> <u>t Income</u>
			30.16%		0.83%			(7.0%)
2011	\$-	\$168,000	\$(50,669)	\$-	\$-	\$117,331	\$58,666	\$4,107
2012	121,438	-	-	(41,933)	(499)	79,006	100,222	7,016
2013	86,022	-	-	(36,691)	(354)	48,977	67,500	4,725
2014	53,702	-	-	(19,656)	(224)	33,822	43,762	3,063
2015	36,885	-	-	(15,725)	(166)	20,994	28,940	2,026
2016	23,020	-	-	(10,483)	(109)	12,428	17,724	1,241
2017	13,669	-	-	<u>(6,552)</u>	<u>(42)</u>	<u>7,075</u>	<u>10,372</u>	<u>726</u>

<u>\$168,000</u>	<u>\$(50,669)</u>	<u>\$(131,040)</u>	<u>\$(1,394)</u>	=	=	<u>\$22,904</u>
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Total expected investment income for future years (2012-17)	<u>\$18,797</u>
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### **Assumptions for Computation of Anticipated Investment Income**

Assumptions are the same as used in the computation of anticipated investment income on all in force policies (example 1-exhibit 4) but based on unearned premiums and claims related to 2012 earned premiums.

### **Premium Deficiency Test Using Expected Investment Income Approach-Anticipated Investments Income Using Cash Flows Associated Only With the Unexpired Portion of the In Force Premium as of December 31, 2011**

#### **(Example 1B-Exhibit 2)**

#### **(Profitable Contracts)**

Unearned premiums at December 31, 2011 ( <a href="#">example 1A-exhibit 1</a> )		\$168,000
Less expected costs (undiscounted):		
Claims and claim adjustment expenses ( <a href="#">example 1A-exhibit 1</a> )	\$131,040	
Maintenance costs ( <a href="#">example 1B-exhibit 1</a> )	1,394	
Unamortized policy acquisition costs (25% of unearned premiums)	<u>42,000</u>	
<i>Subtotal</i>		<u>\$174,434</u>
Premium deficiency before expected investment income		(6,434)
Anticipated investment income ( <a href="#">example 1B-exhibit 1</a> )		<u>18,797</u>
Excess of income over costs		<u>\$12,363</u>

The premium deficiency test performed using the expected investment income approach (anticipated investments income calculated using cash flows associated only with the unexpired portion of the in force

premium) indicates an excess. Therefore, no provision for premium deficiency would be made as of December 31, 2011.

### Example 1C

#### Discounting Approach Using Only the Unexpired Portion of the Contract

This exhibit calculates the present value as of December 31, 2011, of payments for claim costs, claim adjustment expenses, and maintenance costs related to the unearned premium.

#### Assumptions

- The 7 percent compound annual interest rate is the same as in [example 1A-exhibit 4](#) .
- The present value factor used is the average of the beginning of the year and end of the year factors to adjust for the payment of claims and maintenance costs evenly throughout the year.
- The expected claim costs and claim adjustment expenses are related to the 2012 earned premium from [example 1A-exhibit 3](#) .

#### Computation of Present Value (Discounting) of Claims and Maintenance Costs to Be Incurred (Example 1C-Exhibit 1)

<u>Payment Year</u>	<u>Claims Related to 2012 Earned Premium</u>	<u>Maintenance Costs</u>	<u>Total Claims and Maintenance Costs</u>	<u>Present Value Interest Factor</u>	<u>Present Value of Claims and Maintenance Costs</u>
2012	\$41,933	\$1,046	\$42,979	0.965	\$41,475
2013	36,691	742	37,433	0.9018692	33,760
2014	19,656	469	20,125	0.8428684	16,963
2015	15,725	347	16,072	0.7877274	12,660
2016	10,483	228	10,711	0.7361939	7,885
2017	<u>6,552</u>	<u>87</u>	<u>6,639</u>	<u>0.6880316</u>	<u>4,568</u>
	<b><u>\$131,040</u></b>	<b><u>\$2,919</u></b>	<b><u>\$133,959</u></b>	<b>-</b>	<b><u>\$117,311</u></b>

#### Premium Deficiency Test Using Discounting Approach (Example 1C-Exhibit 2) as of December 31, 2011

Unearned premiums at December 31, 2011 ( [example 1A-exhibit 1](#) ) \$168,000

Less expected costs:		
Present value of claims and maintenance costs to be incurred ( <b>example 1C-exhibit 1</b> )	\$117,311	
Unamortized policy acquisition costs (25% of unearned premiums)	<u>42,000</u>	
Subtotal		<u>159,311</u>
Excess of income over costs		<b><u>\$8,689</u></b>

The premium deficiency test performed using the discounted approach also indicates an excess with no provision for premium deficiency required as of December 31, 2011.

The expected investment income approach results in a larger sufficiency in this example because the discounting approach as shown in this example does not give credit for the investment income to be earned in the future on the portion of in force premium in excess of the amount needed to satisfy future claim payments.

The premium deficiency calculation for SAP would be the same as GAAP, except DAC would be excluded for SAP.

**Example 2A**

**Expected Investment Income Approach Using All Cash Flows From In Force Policies**

The following is an example of a premium deficiency test using the expected investment income approach that results in a deficiency.

***Assumptions***

Assume all the same facts as in example 1; however,

- the loss and loss expense ratio is 88 percent instead of 78 percent assumed in the first example.
- expected investment income used in the premium deficiency calculation includes only positive investment income.

**Anticipated Experience On Group of In Force Policies  
(Example 2A-Exhibit 1)**

<u><i>Earned on Unexpired</i></u>	<u><i>Unearned</i></u>	<u><i>In Force</i></u>
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Premium	\$182,000	\$168,000	\$350,000
Actual loss and loss expense ratio	88%	-	-
Expected loss and loss expense ratio	-	88%	-
	<b><u>\$160,160</u></b>	<b><u>\$147,840</u></b>	<b><u>\$308,000</u></b>

**Settlement Pattern of Claims Related to In Force Policies  
(Example 2A-Exhibit 2)**

<i>Payment Year</i>	<u><i>Claims Related to 2011 Earned Premium</i></u>		<u><i>Claims Related to 2012 Earned Premium</i></u>		<u><i>Claims Related to in Force Premium</i></u>	
	<i>%</i>	<i>\$</i>	<i>%</i>	<i>\$</i>	<i>%</i>	<i>\$</i>
2011	32.0	51,251	-	-	16.6	51,251
2012	28.0	44,845	32.0	47,309	29.9	92,154
2013	15.0	24,024	28.0	41,395	21.2	65,419
2014	12.0	19,219	15.0	22,176	13.4	41,395
2015	8.0	12,813	12.0	17,741	9.9	30,554
2016	5.0	8,008	8.0	11,827	6.5	19,835
2017	-	-	5.0	7,392	2.5	7,392
	<b><u>100.0</u></b>	<b><u>160,160</u></b>	<b><u>100.0</u></b>	<b><u>147,840</u></b>	<b><u>100.0</u></b>	<b><u>308,000</u></b>

**Computation of Expected Investment Income  
(Example 2A-Exhibit 3)**

<i>Year</i>	<u><i>Cash Opening Balance</i></u>	<u><i>Premiums Received</i></u>	<u><i>Underwriti ng Costs Paid</i></u>	<u><i>Claims</i></u>	<u><i>Maintenan ce Costs</i></u>	<u><i>Cash Ending Balance Before</i></u>	<u><i>Cash Average Balance (1)</i></u>	<u><i>Investmen t Income (1)</i></u>
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						<u>Investment Income</u>		
						<u>(1)</u>		
		30.16%			0.83%			(7.0%)
2011	\$- \$350,000	(\$105,560)	(\$51,251)	-	\$193,189	\$96,595	\$6,762	
2012	199,950	-	(92,154)	(1,046)	106,750	153,351	10,735	
2013	117,489	-	(65,419)	(742)	51,327	84,406	5,908	
2014	57,238	-	(41,395)	(469)	15,373	36,304	2,541	
2015	17,916	-	(30,554)	(347)	(12,984)	2,465	173	
2016	(12,811)	-	(19,835)	(228)	(32,874)	(22,843)	(1,599)	
2017	(34,469)	-	(7,392)	(87)	(41,948)	(38,211)	(2,675)	
		<u>\$350,000</u>	<u>(\$105,560)</u>	<u>(\$308,000)</u>	<u>(\$2,919)</u>		<u>\$21,845</u>	

Total expected investment income for future years (2012-17) **\$15,083**

(1) Expected investment income for future positive years only is \$19,357 (\$10,735 + \$5,908 + \$2,541 + \$173).

**Premium Deficiency Test Using Expected Investment Income Approach As of December 31, 2011 (Example 2A-Exhibit 4) (Unprofitable Contracts)**

Unearned premiums at December 31, 2011 ( <a href="#">example 2A-exhibit 1</a> )		\$168,000
Less expected costs (undiscounted):		
Claims and claim adjustment expenses ( <a href="#">example 2A-exhibit 1</a> )	\$147,840	
Maintenance costs ( <a href="#">example 2A-exhibit 3</a> )	2,919	
Unamortized policy acquisition costs (25% of unearned premiums)	<u>42,000</u>	
Subtotal		<u>192,759</u>
Premium deficiency before		(24,759)

expected investment income	
Alternative 1: expected investment income, including all investment income ( <b>example 2A-exhibit 3</b> )	<u>15,083</u>
Alternative 1: premium deficiency	<u>(9,676)</u>
Alternative 2: expected investment income, including only positive investment income ( <b>example 2A-exhibit 3</b> )	<u>19,357</u>
Alternative 2: premium deficiency	<u>(\$5,402)</u>

**Journal Entries**

*GAAP (Illustrating Alternative 1)*

Debit amortization expense	\$9,676
Credit DAC	\$9,676

*To Reduce DAC for Premium Deficiency*

If the deficiency for GAAP exceeded unamortized DAC, then the entity would record the following entry for the amount that the premium deficiency exceeds DAC:

Debit provision for premium deficiency	\$XXXX
Credit other liability	\$XXXX

The location on the statement of income for the provision for premium deficiency would be an accounting policy decision that should be consistently applied.

**SAP**

In this example, no premium deficiency for SAP exists because the \$42,000 of remaining unamortized acquisition costs for GAAP had already been expensed for SAP. Thus, under SAP, premium sufficiency is \$32,324.

If there had been a premium deficiency for SAP, the following entry would occur to set up an aggregate write-in liability:

Debit provision for premium deficiency	\$XXXX
Credit aggregate write-ins	\$XXXX

**Example 2B**

**Expected Investment Income Approach Using Investment Income That Is Determined Using Cash Flows Associated With Only the Unexpired Portion of the In Force Premium**

Under this variation of the expected investment income approach, investment income is determined only on the cash flows associated with the unexpired portion of the in force premium and claims related to 2012 earned premiums, with the same changes in assumptions as **example 2A**.

Assume all the same facts as **example 1B**; however,

- the loss and loss expense ratio is 88 percent instead of 78 percent assumed in the first example.
- expected investment income used in the premium deficiency calculation includes only positive investment income.

**Computation of Expected Investment Income  
(Example 2B-Exhibit 1)**

<u>Year</u>	<u>Cash Opening Balance</u>	<u>Premiums Received</u>	<u>Underwr iting Costs Paid</u>	<u>Claims</u>	<u>Maintenan ce Costs</u>	<u>Cash Ending Balance Before Investmen t Income</u>	<u>Cash Average Balance</u>	<u>Investmen t Income</u>
			30.16%		0.83%			(7.0%)
2011	\$-	\$168,000	\$(50,669)	\$--	\$-	\$117,331	\$58,666	\$4,107
2012	121,438	-	-	(47,309)	(499)	73,630	95,481	6,684
2013	80,314	-	-	(41,395)	(354)	38,565	56,098	3,927
2014	42,492	-	-	(22,176)	(224)	20,092	29,328	2,053
2015	22,145	-	-	(17,741)	(166)	4,238	12,165	852
2016	5,090	-	-	(11,827)	(109)	(6,846)	17,724	(183)
2017	(7,029)	=	=	(7,392)	(42)	(14,463)	(10,655)	(746)
		<u>\$168,000</u>	<u>\$(50,669)</u>	<u>\$(147,840)</u>	<u>\$(1,394)</u>	=	=	<u>\$16,694</u>

Total expected investment income for future years (2012-17) **\$12,587**

(1) Expected investment income for future positive years only is \$13,516 (\$6,684 + \$3,927 + \$2,053 + \$852).

**Premium Deficiency Test Using Expected Investment Income Approach as of December 31, 2011  
(Example 2B-Exhibit 2) (Unprofitable Contracts)**

Unearned premiums at December 31, 2011 ( <a href="#">example 2A-exhibit 1</a> )		\$168,000
Less expected costs (undiscounted):		
Claims and claim adjustment expenses ( <a href="#">example 2A-exhibit 1</a> )	\$147,840	
Maintenance costs ( <a href="#">example 2B-exhibit 1</a> )	1,394	
Unamortized policy acquisition costs (25% of unearned premiums)	<u>42,000</u>	
 Subtotal		 <u>191,234</u>
 Premium deficiency before expected investment income		 (23,234)
Alternative 1: expected investment income, including all investment income ( <a href="#">example 2B-exhibit 1</a> )		<u>12,587</u>
 Alternative 1: premium deficiency		 <u>(10,647)</u>
 Alternative 2: expected investment income, including only positive investment income ( <a href="#">example 2B-exhibit 1</a> )		 <u>13,516</u>
 Alternative 2: premium deficiency		 <u>(\$9,718)</u>

**Journal Entries**

*GAAP (Illustrating Alternative 1)*

Debit amortization expense	\$10,647
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Credit DAC \$10,647

*To Reduce DAC for Premium Deficiency*

If the deficiency for GAAP exceeded unamortized DAC, then the entity would record the following entry for the amount that the premium deficiency exceeds DAC:

Debit provision for premium deficiency \$XXXX  
 Credit other liability \$XXXX

The location on the statement of income for the provision for premium deficiency would be an accounting policy decision that should be consistently applied.

**SAP**

- In this example, no premium deficiency for SAP exists because the \$42,000 of remaining unamortized acquisition costs for GAAP had already been expensed for SAP. Thus, under SAP, premium sufficiency is \$31,353.
- If there had been a premium deficiency for SAP, the following entry would occur to set up an aggregate write-in liability:

Debit provision for premium deficiency \$XXXX  
 Credit aggregate write-ins \$XXXX

**Example 2C**

**Discounting Approach Using Only the Unexpired Portion of the Contract**

The following is an example of a premium deficiency test using the discounting approach that results in a deficiency.

Assume all the same facts as in example 1; however, the loss and loss expense ratio is 88 percent instead of 78 percent assumed in the first example.

**Computation of Present Value (Discounting) of Claims and Maintenance Costs to Be Incurred (Example 2C-Exhibit 1)**

<u>Payment Year</u>	<u>Claims Related to 2012 Unearned Premium (88%)</u>	<u>Maintenance Costs (0.83%)</u>	<u>Total Claims and Maintenance Costs</u>	<u>Present Value Interest Factor (7%)</u>	<u>Present Value of Claims and Maintenance Costs</u>
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2012	\$47,309	\$1,046	\$48,355	0.9667	\$46,745
2013	41,395	742	42,137	0.9035	38,071
2014	22,176	469	22,645	0.8444	19,121
2015	17,741	347	18,088	0.7891	14,273
2016	11,827	228	12,055	0.7375	8,891
2017	<u>7,392</u>	<u>87</u>	<u>7,479</u>	<u>0.6893</u>	<u>5,155</u>
	<b><u>\$147,840</u></b>	<b><u>\$2,919</u></b>	<b><u>\$150,759</u></b>	<b>=</b>	<b><u>\$132,256</u></b>

**Premium Deficiency Test Using Discounting Approach as of December 31, 2011  
(Example 2C-Exhibit 2)**

Unearned premiums at December 31, 2011 ( <a href="#">example 2A-exhibit 1</a> )		\$168,000
Less expected costs:		
Present value of claims and maintenance costs to be incurred ( <a href="#">example 2C-exhibit 1</a> )	\$132,256	
Unamortized policy acquisition costs (25% of unearned premiums)	<u>42,000</u>	
Subtotal		<u>174,256</u>
Premium deficiency		<b><u>(\$6,256)</u></b>

**Journal Entries**

*GAAP*

Debit amortization expense	\$6,256
Credit DAC	\$6,256

*To Reduce DAC for Premium Deficiency*

If the deficiency for GAAP exceeded unamortized DAC, then the entity would record the following entry for the amount that the premium deficiency exceeds DAC:

Debit provision for premium deficiency	\$XXXX
Credit other liability	\$XXXX

The location on the statement of income for the provision for premium deficiency would be an accounting policy decision that should be consistently applied.

### **SAP**

In this example, no premium deficiency for SAP exists because the \$42,000 of remaining unamortized acquisition costs for GAAP had already been expensed for SAP. Thus, under SAP, premium sufficiency is \$35,744.

If there had been a premium deficiency for SAP, the following entry would occur to set up an aggregate write-in liability:

Debit provision for premium deficiency	\$XXXX
Credit aggregate write-ins	\$XXXX

### **Medicare Part D**

**3.98** The following paragraphs provide a high level overview of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 that established a new voluntary Medicare prescription drug program (Medicare Part D) for which benefits started January 1, 2006, for health care providers. This is applicable to property and casualty insurance entities that provide such programs. Medicare Part D products can either be offered by entities as a standalone product or included as a component of a Medicare Advantage plan. The underlying contract with the beneficiary in Medicare Part D programs generally provides health insurance (prescription drug) coverage for periods of one calendar year, with premiums adjustable annually.

**3.99** After total costs paid by the enrollee, including the deductible, copays, and coinsurance under the initial coverage limit, exceed the out-of-pocket threshold, the enrollee is only responsible for a proportion (namely, the coinsurance percentage subject to a minimum copay) of any further drug costs. The regulations also permit a prescription drug plan (PDP) sponsor to offer enhanced alternative coverage in which at least one key aspect of the benefit design (deductible, cost sharing, or initial coverage limit) is richer than the standard plan. Such additional benefits are referred to as supplemental benefits in the regulations. The Centers for Medicare & Medicaid Services (CMS) will reimburse PDP sponsors for a percentage or amount of all claims above the out-of-pocket threshold. This reimbursement is known as the *reinsurance subsidy*. Further, the government provides a Low Income Cost Share (LICS) subsidy to participants that fall below a certain percentage of the poverty line. CMS will reimburse PDP sponsors for any cost sharing they pay on behalf of a Low Income Subsidy (LIS) member. To the extent that the PDP sponsor's adjusted allowable risk corridor costs vary in either direction from a target amount, risk sharing exists between the CMS and PDP sponsor. Many Medicare Part D plans have a benefit design that includes a coverage gap. When a member falls within this gap, the PDP sponsor generally provides little to no benefit. Beginning in 2011, drug manufacturers agreed to provide a discount to a member's qualifying brand drug costs for claims that are incurred while the member is within this gap. The claims are initially paid by the PDP sponsor until they are reimbursed by the manufacturer.

**3.100** Medicare Part D is a complex arrangement that continues to evolve and includes the following components:

- Traditional insurance in the form of health insurance for prescription drugs
- Coinsurance, subject to a minimum copay, that represents the portion paid by the enrollee after other limits are met
- Cost sharing amounts for LIS members that are paid by the federal government
- Risk corridor payments to or from Medicare by the plan sponsor based on threshold limits
- Manufacturer discounts for claims that fall within the coverage gap
- Option for supplemental benefits related to an enhanced alternative coverage
- A late enrollment fee that is a penalty assessed to beneficiaries who enroll outside the normal enrollment windows

**3.101** Those components determined to be insurance should be accounted for under FASB ASC 944, and other nonrisk premiums determined to be pass-throughs (that is, the reinsurance subsidy, the LICS subsidy, and the manufacturer discounts) that do not have any insurance risk should be accounted for as a deposit under FASB ASC 340. Two methods have been utilized in practice for accounting for the risk corridor payments:

- A retrospective refund arrangement under [FASB ASC 944-605-25-14](#) based on the experience to date following a model based on accounting for multiple year, retrospectively rated insurance contracts under FASB ASC 944.
- A retrospective premium adjustment on a retrospectively rated contract in accordance with [FASB ASC 944-605-25-2](#). This paragraph indicates that if the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. Retrospective premiums should be estimated at the beginning of the plan year based upon actuarially determined models and adjustments should be made based upon revisions to those estimates in each reporting period. Retrospective premium adjustments estimated for the portion of the policy period that has expired shall be considered and immediately recorded as an adjustment to premium. [FASB ASC 944-605-25-2](#) also requires that if the ultimate premium cannot be reasonably estimated, the cost recovery method or deposit method may be used until the ultimate premium can be reasonably estimated.

**3.102** The National Association of Insurance Commissioners Emerging Accounting Issues Working Group issued Interpretation 05-05, *Accounting for Revenues Under Medicare Part D Coverage*, to provide guidance to insurers on how to present various funds to be received under the Medicare Part D program. Interpretation 05-05 requires the application of existing SAP (SSAP No. 47, *Uninsured Plans*; No. 66; and No. 54, *Individual and Group Accident and Health Contracts*, depending upon the nature of the funds received).

## **Accounting for Contracts That Do Not Transfer Insurance Risk**

### ***Generally Accepted Accounting Principles***

**3.103** FASB ASC 340-30 provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. As discussed in [FASB ASC 340-30-05-2](#), the transfer of insurance risk requires transferring both timing risk and underwriting risk. FASB ASC 340-30 applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except long duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to as deposit accounting. FASB ASC 340-30 neither addresses when deposit accounting should be applied nor provides criteria to make that determination. This determination should be made on a case-by-case basis. [FASB ASC 720-20-25-1](#) provides guidance on when deposit accounting should be applied to insurance and reinsurance contracts. The accounting by the insured and insurer are symmetrical, except as noted in [FASB ASC 340-30-35-6](#) when contracts transfer only significant underwriting risk and if average rates are used as the discount rate for determining the deposit asset and liability. See further discussion of deposit accounting and risk transfer evaluation in chapter 6 of this guide.

### ***Statutory Accounting Principles***

**3.104** Under SAP, guidance on accounting for contracts that do not transfer risk can be found in SSAP No. 52, *Deposit-Type Contracts*, which generally follows the same principles as GAAP. Structured settlements should be recorded consistently with the accounting provided for structured settlements in SSAP No. 65, *Property and Casualty Contracts*. Additional guidance can be found in SSAP No. 75, *Reinsurance Deposit Accounting-An Amendment to SSAP No. 62R, Property and Casualty Reinsurance*. See further discussion of risk transfer evaluation and deposit accounting in [chapter 6](#) of this guide.

### **Disclosure Considerations**

**3.105** Generally, for an operating insurance entity, premiums are significant to the entity's operations and will often result in significant balances and accounts reported in the entity's financial statements. These factors should be considered when evaluating disclosures required under [FASB ASC 235-10-50-1](#), which requires disclosure of information about the accounting policies adopted by an entity. In addition, GAAP and SAP may specify disclosures that must be made, when relevant, related to premium, acquisition costs, and premium receivable.

### ***Premium Revenue and Premium Adjustments***

**3.106** As required by [FASB ASC 944-20-50-7](#), information should be disclosed that enables financial statement users to understand the factors affecting the present and future recognition and measurement of financial guarantee insurance contracts.

### ***Premium Receivable***

**3.107** The financing and lending activities of insurance entities are included in [FASB ASC 310-10-50](#), which sets out the following disclosure requirements, unless the trade receivables have payment terms of less than 12 months and arise from sales of insurance policies. Examples of insurance contract arrangements that may require disclosures under this guidance include insurance contracts with contract terms greater than 12 months or arrangements where premiums are withheld for a period greater than 12 months and receivables resulting from reinsurance agreements.

Entities should consider whether the following disclosures are applicable:

- a. Significant Accounting Policies as required in **FASB ASC 310-10-50-2** , 310-10-50-45-2, and **310-10-50-4**
- b. Assets Serving as Collateral as required in **FASB ASC 860-30-50-1A**
- c. Nonaccrual and Past Due Financing Receivables as required in paragraphs 6, 7, and 7A of **FASB ASC 310-10-50**
- d. Accounting Policies for Off Balance Sheet Credit Exposures as required in **FASB ASC 310-10-50-9** , in addition to disclosures required by FASB ASC 450-20
- e. Foreclosed and Repossessed Assets as required in **FASB ASC 310-10-50-11** and **310-10-45-3**
- f. Accounting Policies for Credit Loss Related to Financing Receivables as required in **FASB ASC 310-10-50-11B**
- g. Impaired Loans as required in **FASB ASC 310-10-50-14A**
- h. Credit Quality Information as required by paragraphs 28 and 29 of **FASB ASC 310-10-50**
- i. Modifications as required by paragraphs 33 and 34 of **FASB ASC 310-10-50**

### ***Financial Guarantee Insurance Contracts***

**3.108** For financial guarantee insurance contracts, **FASB ASC 944-310-50-3** requires insurance entities to disclose the following for each annual and interim period:

- a. For financial guarantee insurance contracts where premiums are received as payments over the period of the contract, rather than at inception, all of the following:
  - 1. The premium receivable as of the date(s) of the statement of financial position and the line item in the statement of financial position where the amount is reported (if not presented separately)
  - 2. The unearned premium revenue as of the date(s) of the statement of financial position and the line item in the statement of financial position where the amount is reported (if not presented separately)
  - 3. The amount of accretion on the premium receivable and the line item in the statement of income where that amount is reported (if not presented separately)
  - 4. The weighted average risk free rate used to discount the premiums expected to be collected
  - 5. The weighted average period of the premium receivable
- b. A schedule of premiums expected to be collected related to the premium receivable detailing both of the following:

1. The four quarters of the subsequent annual period and each of the next four annual periods
2. The remaining periods aggregated in five year increments
- c. A roll forward of the premium receivable for the period, including all of the following:
  1. The beginning premium receivable
  2. Premium payments received
  3. New business written
  4. Adjustments to the premium receivable, including all of the following:
    - i. Adjustments for changes in the period of a financial guarantee insurance contract
    - ii. An explanation of why the adjustments in item (c)(4)(i) occurred
    - iii. Accretion of the premium receivable discount
    - iv. Other adjustments with explanations provided
  5. The ending premium receivable

### ***Acquisition Costs***

**3.109** The following should be disclosed for DAC, as required by **FASB ASC 944-30-50-1** :

- a. The nature and type of acquisition costs capitalized
- b. The method of amortizing capitalized acquisition costs
- c. The amount of acquisition costs amortized for the period

### ***Contracts That Do Not Transfer Insurance Risk***

**3.110** Paragraphs 1-2 of **FASB ASC 340-30-50** require the following disclosures:

- a. Entities shall disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position
- b. Insurance enterprises shall disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:
  - i. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses
  - ii. Any adjustments of amounts initially recognized for expected recoveries (the individual

components of the adjustment [meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries] should be disclosed separately)

iii. The amortization expense attributable to the expiration of coverage provided under the contract

## Auditing Premiums and Acquisition Costs <sup>5</sup>

<sup>5</sup> The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of nonissuers. See the " **Applicability of Generally Accepted Auditing Standards and PCAOB Standards** " section of the preface to this guide for a discussion of the definitions of issuers and nonissuers as used throughout this guide. To assist auditors conducting audits of issuers in accordance with PCAOB standards, **appendix E** , " Clarified Auditing Standards and PCAOB Standards," of this guide compares the clarified standards to the PCAOB standards. Further, considerations for audits of issuers in accordance with PCAOB standards may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*. **Audit Planning**

**3.111** In accordance with **AU-C section 300** , *Planning an Audit* (AICPA, *Professional Standards*), the auditor should plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. The nature, timing, and extent of planning vary with the size and complexity of the entity and with the auditor's experience with the entity and understanding of the entity. Unless an insurance entity is a startup or in runoff, premiums will generally be significant to the financial statements and related disclosures. Refer to **chapter 2** , "Audit Considerations," for a detailed discussion of audit planning.

### Consideration of Fraud in a Financial Statement Audit

**3.112** Risks are inherent in all audit engagements, including the possibility that fraudulent acts may cause a material misstatement of financial statements. **AU-C section 240** , *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), addresses the auditor 's responsibilities relating to fraud in an audit of financial statements. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Readers should refer to additional discussion of **AU-C section 240** in **chapter 2** of this guide.

### Audit Risk Factors-Premiums and DAC

**3.113** As discussed in **paragraph .A1** of AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), *audit risk* is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when

a. determining the nature and extent of risk assessment procedures to be performed;

- b. identifying and assessing the risks of material misstatement;
- c. determining the nature, timing, and extent of further audit procedures; and
- d. evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

**3.114** Experience has demonstrated that audit risk may be greater in certain areas than in others. Significant transaction cycles of property and liability insurance entities include the premium cycle, the claims cycle, the reinsurance cycle, and the investment cycle. Risk factors specific to the premium cycle include, but are not limited to, the authorization and existence of policy or contract issuance, the completeness and accuracy of the premium earned, the existence and valuation of premium receivable, and the valuation of unearned premium, including premium deficiencies. Risk factors specific to acquisition costs include, but are not limited to, acquisition costs properly identified as costs that are related directly to the successful acquisition of new or renewal insurance contracts. These risk factors, internal control considerations, and examples of audit procedures for the insurance entity are discussed further herein.

**3.115** Identification of significant accounts and disclosures by the auditor is part of the planning process. As required by **AU-C section 315**, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements, the auditor should obtain an understanding of the relevant industry, regulatory, and other external factors, including the applicable financial reporting framework, and the nature of the entity.

**3.116** Significant disclosures for the premium cycle include the accounting policy for premium recognition for the various types of insurance contracts as well as the accounting policy for contracts that are accounted for as deposits. Significant disclosures for acquisition costs include information about the nature and type of acquisition costs capitalized, the method of amortizing capitalized acquisition costs, and the amount of acquisition costs amortized for the period.

### Management Estimates

**3.117** When evaluating risk associated with management estimates, factors for consideration include the entity and its environment, management's historical estimation reliability, management bias, understanding of relevant controls, subjectivity in underlying assumptions, and any specific significant risks associated with estimates. **AU-C section 540**, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), requires that the auditor obtain an understanding of how management makes the accounting estimates and the data on which they are based. As discussed in **paragraph .13** of AU-C section 540, the auditor may decide, based on the nature of the accounting estimate, to do one or more of the following:

- Develop a point estimate or range to evaluate management's point estimate
- Test the operating effectiveness of the controls over how management made the accounting estimate together with appropriate substantive procedures
- Test how management made the accounting estimate and the data on which it is based

**3.118** The auditor may also decide to involve an expert. The auditor should evaluate whether the data

relevant to the audit used by involved parties such as management, and, as applicable, management's internal or external specialist as well as the auditor's internal or external specialist, is sufficiently reliable, including determining whether the data is complete, accurate, and consistent. **AU-C section 540** sets out guidance for the auditors when auditing estimates.

**3.119** Certain premium accounts may include significant management estimates, such as the following:

- Premium adjustments (for example, on workers compensation policies), retrospectively rated premiums, or reporting form policies
- Commission adjustments (for example, profit commission or volume bonuses)
- Premium estimates on coverages for which the insurance company is contractually bound or for which coverage has been cancelled however have not yet been processed in the premium system
- Estimate of uncollectable premium receivable amounts

### **Risk of Material Misstatement-Inherent Risk Factors**

**3.120** As discussed in **AU-C section 330**, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), inherent risk is the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure. As part of the auditor's assessment of inherent risk, the auditor may consider those factors related to premium revenue recognition, including factors relating to underwriting policies, distribution channels, management, premium billing and collection operations, and product line characteristics. Such factors might encompass the following:

- a. The premium rates charged are significantly below the industry averages for similar kinds of products, or the analysis of contract pricing or profitability is inadequate.
- b. Relationships of cash receipts to recorded premiums are inconsistent with the kind or volume of contracts written.
- c. The insurance entity's product lines include experience rated insurance arrangements.
- d. There are an increasing number of cancellations and reinstatements.
- e. Changes in tax legislation affect the insurance entity's products.
- f. Regulations affect the insurance entity's operations relative to its market conduct (for example, content of marketing material, licensing of sales force, and contract forms).
- g. Regulation of capital capacity restricts the insurance entity's ability to write new business.
- h. The requirements for the licensing of agents or other intermediaries are not adhered to or require changes to agent contracts.
- i. Reinsurance agreements have been revised and are becoming more complex, or reinsurance has become unavailable at the insurance entity's desired retention level or cost.
- j. New specialized products are introduced or rapid growth develops in previously limited product lines.

k. Dependency on investment and similar contracts in which the fixed rate in the contract exceeds the rate of return on the related investments.

l. Market trends indicate a saturated demand for the entity's product.

**3.121** The auditor may also consider factors related to commissions, general expenses, and DAC, including factors relating to management, commission processing, cost allocation, and expense management. Such factors might encompass the following:

a. Management's philosophy toward deferral and amortization of contract acquisition costs, evaluation of the kind of costs that are deferred (including product development costs), and tests for premium deficiencies are considered aggressive in comparison to the industry.

b. Management tends to change its philosophy toward the deferral and amortization of contract acquisition costs from year to year.

c. Commission rates are significantly above industry averages for similar products and distribution systems.

d. The entity has changed distribution methods or compensation and incentive arrangements with agents and brokers.

e. Requirements for licensing agents or other intermediaries are not adhered to or require changes in compensation contracts.

f. Qualified actuaries are not used in the calculation of DAC balance, recoverability testing, or loss recognition evaluation.

## Internal Control

**3.122** **Paragraph .04** of AU-C section 315 defines internal control as

a process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives.

**3.123** Internal control consists of the following five interrelated components:

a. Control environment

b. The entity's risk assessment process

c. The information system, including the related business processes relevant to financial reporting and communication

d. Control activities relevant to the audit

- e. Monitoring of controls

**3.124** **AU-C section 315** requires the auditor to obtain an understanding of these components of the entity's internal control. **Paragraphs 2.31-.41** of chapter 2 of this guide discuss in detail the components of internal control. This section will discuss certain components of a property and liability insurance entity's internal control as they relate to premiums and DAC.

### **Control Environment**

**3.125** The control environment comprises the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific control policies or procedures on the operations of the entity. As related to premium revenue recognition of a property and liability insurance entity, conditions that could impact the effectiveness of the control environment may include the following:

- a. There is a substantial increase in the volume of a particular product or a significant change in the mix of business that might adversely affect control design or operating effectiveness.
- b. Changes to the entity's financial or regulatory reporting requirements challenge the adequacy of the premium accounting system used by the insurance entity or third-party servicing agent and coordination with key processing systems.
- c. Increases in the suspense accounts or level of backlogs of premium transactions exists resulting in an excessive processing error rate.
- d. Whether operations are highly decentralized or have significant reliance on third parties or agents for customer correspondence, premium billing, and collection or are very centralized.
- e. The volume and complexity of premium transactions is increasing, raising questions about whether the staff is competent and experienced to handle it.
- f. New products or contracts are being written that require different revenue recognition policies or accounting procedures or that have unique processing requirements.

**3.126** Such factors that relate to DAC transactions include the following:

- a. Whether the entity has accounting systems that provide sufficient detail to accurately identify deferrable costs and allocate costs to groups of contracts or lines of business
- b. Whether the entity periodically performs cost studies to validate allocation methodologies
- c. Whether the entity has sophisticated cost allocation systems in place to perform year-to-year comparisons of acquisition costs and other expenses by appropriate contract groupings or by line of business
- d. Whether there is excessive reliance on one individual for DAC calculations

## Risk Assessment Process

**3.127** As discussed in [paragraphs .16-.18](#) of AU-C section 315, the auditor should obtain an understanding of whether the entity has a process for

- a. identifying business risks relevant to financial reporting objectives;
- b. estimating the significance of the risks;
- c. assessing the likelihood of their occurrence; and
- d. deciding about actions to address those risks.

**3.128** The auditor should obtain an understanding of the entity's risk assessment process related to premiums and DAC and the results thereof. If the entity has not established such a process or has an ad hoc process, the auditor should discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor should evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances or determine whether it represents a significant deficiency or material weakness in the entity's internal control.

## Control Activities

**3.129** Control activities are the policies and procedures that help ensure that management's directives are carried out and that necessary actions are taken to address risks to achieve the entity's objectives. The auditors should gain an understanding of those control activities the auditor deems necessary to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks, which may include, but are not limited to, the following:

- a. Premiums - Principal lines of business written (property or liability, commercial or personal, and so on)
  - Geographic, product, or other concentrations
  - Rate-making environment and policies or practices
  - Changes in product mix or emphasis
  - Extent of retrospectively rated or reporting form business and the estimability and timeliness of retrospective revenue or expense determinations
  - Unusual, erratic, or substantial changes in premiums in force
  - Propriety of premium revenue recognition methods used
  - Evidence or expectations of increased competition, market saturation, or declining demand
  - Significant accounting procedures performed at other locations, such as branch offices versus the home office

- Principles and policies used by the entity in recognition of premiums
  - Statistical coding and processing systems used to support underwriting functions
- b. Receivables - Suspense account activity and condition (for example, large or old uncleared items or numerous outstanding debt and credit items)
- Agent statement terms and financing arrangements (for example, extended credit terms, expense supplements, loans, and profit sharing arrangements)
  - Agency concentration (for example, significant volume from limited numbers of agents)
  - Agency profitability (for example, derivation of substantial unprofitable business from particular agents)
  - Nonadmitted asset trends (for example, sizable past due or unclear balances)
  - Commission arrangements (for example, contingent commissions, or unusual commission structures that may encourage agent fraud)
  - Agent binding authorities to accept underwriting risks or settle claims without prior approval
  - Agent commingling of insurer or insured funds collected in a fiduciary capacity (for example, use of third-party funds for operating or personal purposes)
  - Reasonableness of estimates for earned but unbilled premiums
  - Adequacy of premium installment payments to provide sufficient protection in the event of policy cancellation
- c. Deferred policy acquisition costs - Guidelines and systems are in place to identify costs directly related to the successful acquisition of new or renewal insurance contracts
- Nature of costs incurred and complexity in determining if such costs are deferrable
  - Frequency and adequacy of recoverability (premium deficiency) tests, particularly regarding line of business groupings and estimated loss-ratio projections

### **Audit Procedures Responsive to the Assessed Risks of Material Misstatement**

**3.130** Risk assessment activities include determining the relevant assertions related to the significant accounts identified, determining the audit objectives, and assessing inherent risk of error of other significant risks (for example, nonroutine transactions or risk of fraud), and planning the involvement of others. As required by **AU-C section 330**, the auditor should design and perform further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level. The auditor should determine planned reliance on controls and the nature, timing, and extent of substantive testing, including whether the substantive evidence is planned from tests of details or substantive analytics.

**3.131** If the auditor identifies a significant risk and is only performing substantive procedures, those procedures should include a test of details. If procedures to respond to the significant risk include both a test of controls and substantive procedures, the auditor may select substantive analytical procedures if

the controls are operating effectively.

*Considerations for Audits Performed in Accordance With PCAOB Standards*

For audits performed in accordance with the Public Company Accounting Oversight Board's (PCAOB's) auditing standards for significant risks, paragraph 11 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks.

**Audit Consideration Chart**

**3.132** The auditor may consider the following specific audit objectives, examples of selected control activities, and auditing procedures in auditing account balances and classes of transactions related to premiums and acquisition costs. However, these are illustrative and auditors should develop tests that are appropriate to the risk of material misstatement in the circumstances of the engagement.

**Audit Consideration Chart-Premiums and Deferred Acquisition Costs**

<i>Financial Statement Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Selected Control Activities</i>	<i>Examples of Auditing Procedures</i>
<b>Existence and Authorization</b>	Premiums, commissions, and revenue and expense amounts recorded must relate to policies issued or in force during the period. Issued insurance contracts are properly authorized.	Unissued policy forms are physically controlled. Policy applications are properly registered. System configuration and access controls. Documented binding or underwriting authorities are verified prior to contract issuance and processing.	Confirmation of policy and premium Obtain evidence about proper issuance by <ul style="list-style-type: none"> <li>• checking policy file for signed application and underwriting approval.</li> <li>• tracing to master file data such as policy number, name, effective date, kind of policy, coverage limits, premium, payment mode, and agent.</li> <li>• comparing premiums to cash receipts records.</li> </ul>

Check daily reports for underwriting approval, calculation of premiums and commissions, and proper recording of premium payments.

Reconcile premiums and commissions to agents' reports.

Trace selected premiums transactions to premium register to check that policy terms, lines of business, and premium amounts have been properly recorded.

Reconcile monthly summary of premiums written direct, assumed, and ceded and related commission with general ledger.

Test that agents submitting applications are licensed, and inspect agency agreements.

Recorded deferred acquisition costs (DAC) balances related to successful efforts represent actual costs that meet the entity's criteria for deferral.

Changes in agents' contracts and reinsurance agreements that may affect commissions are reviewed for any adjustments that may be required in deferral calculations. Any related

Test contract master file data used to calculate DAC balances, contract type, payment mode, issue date, and current status of contract). Test that transactions are correctly recorded in the in force files.

adjustments are approved by appropriate personnel.

Review and test time or cost studies or other analyses related to determining successful efforts.  
 Review the company's process for how commissions and bonuses are paid across various distribution channels, and what are the structures for different employees.  
 Review company's assumptions for successful efforts factor.

**Completeness**

Premium amounts include premiums from all policies and are accurately compiled.

Policies are recorded on a timely basis in the detail policy records, and records are reviewed for recording of all policy numbers.  
 Guidelines are established for coding policies, and coding is reviewed for accuracy.  
 Input, output, and data center controls are maintained to ensure that all changes to detail policy records are processed properly.

Test that premiums are recorded as described previously.  
 Assess control over policy forms and policy issuance by

- testing whether policies supplied to agents are promptly entered on policy control records.
- inspecting policy numbers issued and testing procedures for investigation of missing numbers.
- reconciling policy allotment register to underwriting reports of new business.
- testing whether daily reports are recorded before filing.

Check calculation of premiums to premium rate tables.

			Compare ratios of commissions to premiums written with ratios of prior years, and investigate significant fluctuations.
	Agents' balances include all amounts due to or from agents as of balance sheet date.	Amounts included in commission calculations are reconciled to premiums written. Detailed agent's accounts are reconciled to the general ledger.	Test that premiums and commissions are recorded as described earlier. Trace selected commission rates to commission schedules.
<b>Rights and Obligations</b>	Return premiums, policyholder dividends, and retroactive premium adjustments are properly recorded.	<p>Policy endorsements and cancellations or other changes are approved; determinations of additional or return premiums are also reviewed.</p> <p>Policyholder dividends, retrospective premiums, and experience rated premiums are reviewed and approved.</p> <p>Premium adjustments are compared with policy provisions, and dividends are compared with dividend declaration for compliance.</p>	<p>Test the propriety of return premiums by inspecting evidence of cancellation on policy face and by obtaining evidence about adherence to entity policy regarding cancellation method.</p> <p>Test that policyholder dividends comply with authorization, and reconcile amounts with underlying policy records.</p> <p>Inspect transactions on periodic reporting policies to test whether periodic reports are received according to terms of policies, audits required by policies are performed, and premium deposits and additional or return premiums are properly calculated and recorded.</p> <p>Inspect premiums recorded for retrospectively rated</p>

policies to test whether entity procedures and policy terms have been followed in determining premiums and whether claims data have been included in the calculations.

Premium and loss data underlying calculations are reconciled to the records, and calculations are reviewed and approved.

Reinsured policies are properly identified, and premiums on ceded reinsurance are properly recorded and reported to assuming entities.

Risks covered by reinsurance agreements are identified, properly designated, recorded in the premium billing and in force files, and reported to the assuming entity.

Test whether risks in excess of retention amounts are reinsured. Test computation of reinsurance premiums and commissions; trace to reinsurance records. Trace information from premium records to reports sent to reinsurers. Test the propriety of reinsurance balances payable by reference to reinsurance agreements and policy records.

**Valuation or Allocation** Premium revenues and unearned premium reserve are recorded properly.

Premium register is balanced periodically to update premiums in force. Premiums written are recorded in the general ledger and are reconciled periodically to premiums entered in statistical records and the premium register. Return premiums are

Inquire about the method for recognizing premium revenue and determining unearned premium reserves; check consistency of its application with prior years. Inspect recording of unearned premium reserves by reconciling additions and deletions in

	<p>reviewed for reasonableness by comparison to original premiums.</p>	<p>force for selected periods back to original documentation and by checking calculation of unearned premiums.            Test that the unearned premium reserves are correctly reduced for ceded insurance.</p>
<p>Uncollectible agents' balances are identified and accounted for.</p>	<p>Agents' balances are periodically aged in conformity with statutory requirements.</p>	<p>Compare aged trial balance of agent's balances with similar trial balances of previous periods, and investigate significant fluctuations.            Test collectability by inspecting subsequent collections or by inspecting history of receipts.            Evaluate the adequacy of the allowance for doubtful accounts, including suspense items.</p>
	<p>Delinquent accounts are investigated and write-offs of bad debts and unreconciled items are approved.            Advances to agents are approved in accordance with entity procedures.            Statements of transactions and balances are periodically sent to agents.</p>	<p>Test whether agents' balances considered to be nonadmitted assets were properly excluded from the statutory statements and included in the generally accepted accounting principles (GAAP) statements only to the extent deemed collectible.</p>
<p>Acquisition costs are properly capitalized, amortized and are recoverable.</p>	<p>Acquisition costs are capitalized in accordance with accounting policy based.            Amortization of deferred</p>	<p>Inspect documentation of procedures for recording acquisition costs.            Inspect the support for DAC.</p>

costs is compared for consistency with premium recognition.	Test whether acquisition costs are properly capitalized and amortized on a consistent basis. Also test whether the balance at year-end is reasonably expected to be recovered.
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