Insurer Statutory Accounting

**Part 1 - Statutory Accounting Concepts**

In the United States, insurers produce a financial statement known as the National Association of Insurance Commissioners (NAIC) Annual Statement. This statement is filed with state insurance departments for regulatory purposes and is based on statutory accounting principles (SAP).

SAP are based on US generally accepted accounting principles (GAAP). When GAAP changes, the NAIC reviews SAP to determine whether any changes are needed Although SAP and GAAP are similar in many ways, they differ in how they value many assets and liabilities and recognize many revenues and expenses. **Overall, SAP is more conservative than GAAP in reporting the financial position of an insurer**.

**Valuation**

**Policyholders’ surplus**: Under statutory accounting principles (SAP), an insurer’s total admitted assets minus its total liabilities.

**Accounting Equation**: The equation that relates assets to liabilities and owner’s equity.

**Matching Principle**: An accounting rule that requires expenses incurred in generating revenues to be matched against those revenues.

An insurer’s SAP balance sheet shows its assets (the value of property that the insurer owns); liabilities (amounts that the insurer owes to others); and policyholders’ surplus, commonly called surplus. Policyholders’ surplus is a residual amount that remains after subtracting liabilities from assets, similar in concept to shareholders’ equity (owners’ equity) under GAAP. By using the term “policyholders’ surplus”, SAP emphasizes the solvency perspective taken by regulators for the protection of policyholders.

***Question: Use the accounting equation to represent the SAP balance sheet***

**The accounting equation can be used to represent the contents of a SAP balance sheet and illustrates that a balance sheet must always remain in balance: ALPS**

**Admitted assets = Liabilities + Policyholders’ surplus**

Rearranging the equation and placing policyholders’ surplus on the left side results in:

Policyholders’ surplus = Admitted assets – Liabilities

When assets and liabilities change in value, policyholders’ surplus also changes, as illustrated by the accounting equation. For example, when an insurer’s assets increase relative to its liabilities, its policyholders’ surplus also increases. The opposite occurs when an insurer’s assets decrease relative to its liabilities. Therefore, the practices that an insurer employs to valued its assets and liabilities directly affect its level of policyholders’ surplus.

**Conservative valuation of Policyholder’s Surplus**

In valuing most assets and liabilities, SAP adopts a conservative approach, resulting in a conservative statement of policyholders’ surplus. This is known as the liquidation perspective because it emphasizes practices that value the insurer as if it were to immediately cease operations. **Assets are valued at what they would bring in a quick sale, and liabilities are valued at the highest point in their range of possible values.** Under SAP, illiquid assets are not counted as “assets” and therefore are not counted toward policyholders’ surplus.

***Question: What is the purpose for policyholders’ surplus in an insurer’s financial management***

**Policyholders’ surplus provides a cushion to ensure that an insurer has sufficient resources to meet its obligation to policyholders**. Unforeseen circumstances can affect an insurer’s financial position.

**Promoting Comparability of Financial Statements**

A key accounting concept is that an organization should be valued as if it will continue to operate indefinitely. This is known as the going concern concept. Treating an organization as a going concern requires accounting practices that take a long-term view of the organization. For example, an asset may be required to be recorded at its long-term value, avoiding the influence of short-term market shifts. For insurers, accounting practices based on the going concern concept help prevent unnecessary short-term shifts in policyholders’ surplus and promote comparability of financial statements from period to period.

SAP recognizes the importance of treating an insurance company as a going concern. However, conflicts often arise between practices that support the going concern perspective and those that emphasize insurer liquidity.

**Recognition**

**Recognition relates to the timing of revenues and expenses. The matching principle provides guidance for the recognition of revenues and expenses, and it allows the profitability of an organization to be accurately measured.**

***Question: Why should an insurer recognize the premium revenue evenly over the term of the policy, rather than when it receives payment***

In a service industry such as insurance, revenue is recognized when the service is provided. **Although the insured may pay the premium in full at the policy inception date, the insurer provides the service (protection against losses) over the term of the policy. Therefore, the insurer should recognize the premium revenue evenly over the term of the policy,** rather than when it receives payment. Receivables, such as agents’ balances due, should be recognized in a similar way unless they are deemed uncollectible.

Policy acquisition costs are incurred when a policy is issued and support the premium revenue earned throughout the policy’s term. Based on the matching principle, policy acquisition and similar up-front costs should be recognized evenly over the term of the policy so they can be matched with the associated revenues.

SAP takes a conservative approach in recognizing many revenues and expenses. Some expenses are immediately recognized even though the recognition of their associated revenues is deferred. This emphasizes the liquidation perspective and a conservative statement of policyholders’ surplus.

**Part 2 – Statutory Accounting Principles (SAP) Compared With GAAP**

Insurers are required to prepare financial statements using statutory accounting principles (SAP) but may also be required to prepare a second set of financial statements using generally accepted accounting principles (GAAP). These different accounting approaches often produce significant differences in the reported value of assets, liabilities, equity, and earnings.

***Question: What are the fundamental differences in the objective of generally accepted accounting principles (GAAP) and statutory accounting principles (SAP) that cause valuation disparities***

**The valuation disparities arise from a fundamental difference in the objective of GAAP ad SAP. GAAP treats a business as a going concern and focuses on measuring earnings from period to period. SAP is primarily focused on solvency and the ability of the insurer to meet its obligations to policyholders**.

**Non-admitted and Admitted Assets**

Non-admitted assets: Types of property, such as office furniture and equipment, that regulators do not allow insurers to show as assets on financial statements because these assets cannot readily be converted to cash at or near their market value. Includes uncollected premiums over 90 days old.

Admitted assets: Assets meeting minimum standards of liquidity that an insurer is allowed to report on its balance sheet in accordance with statutory accounting principles.

***Question: Explain the difference between SAP and GAAP Accounting treatment of each of these balance sheet or income statement items***:

**SAP imposes a strict valuation rule that excludes certain assets that cannot be readily converted to cash (that is, those assets that are not liquid). These are referred to as non-admitted assets. By contrast, GAAP counts all assets regardless of their liquidity**.

Because assets on a SAP balance sheet are reduced by the value of the non-admitted assets, surplus is reduced by an amount equal to the value of the non-admitted assets. An enhanced accounting equation represents the exclusion of non-admitted assets from a balance sheet:

Total assets – Non-admitted assets = Liabilities + Policyholders’ surplus

Rearranging the equation and placing policyholders’ surplus on the left side results in:

Policyholders’ surplus = [Total assets – Non-admitted assets] – Liabilities

Excluding non-admitted assets from total assets and from surplus, as presented, exemplifies the SAP liquidation valuation criterion because these assets are not liquid assets. This approach is a conservative method of evaluating and insurer’s policyholders’ surplus and helps to assess insurer solvency.

Insurers report a variety of admitted assets on their statutory balance sheets, including investments and other types of assets. Invested assets constitute the bulk of assets and include items such as cash stock, bonds, and real estate investments. Other assets include items such as premiums receivable.

**Bond Investments**

***Question: Explain the difference between SAP and GAAP Accounting treatment of each of these balance sheet or income statement items***

**Under SAP, most bonds are valued at an adjusted cost amount called amortized cost, which evenly amortizes any premium or discount over the remaining life of a bond. Under GAAP, amortized cost valuation is permitted only if the insurer is able and intends to hold the bond to maturity; otherwise, bonds are classified as “available for sale” or “trading” and reported at market value**.

**Premium Balances Due From Agents**

***Question: Explain the difference between SAP and GAAP Accounting treatment of each of these balance sheet or income statement items***

**Under SAP, premium balances more than ninety days past due are non-admitted. GAAP requires that premium balances due from agents be offset with a reserve for amounts that are deemed uncollectible.**

**Reinsurance Recoverables**

***Question: Explain the difference between SAP and GAAP Accounting treatment of each of these balance sheet or income statement items***

**Reinsurance recoverables: Amounts for losses and loss adjustment expenses owed to an insurer under reinsurance agreements covering paid losses**.

**Under SAP, reinsurance recoverables for unpaid losses and loss adjustment expenses are netted (subtracted) from loss and loss adjustment expense reserves, so there is no need to show these recoverables as an asset. Under GAAP, these same reinsurance recoverables are shown as an asset and are not netted (subtracted) from loss and loss adjustment expense reserves**.

**Provisions for Reinsurance**

Unauthorized reinsurer: A reinsurer that is not licensed or otherwise authorized to do business in the primary insurer’s state of domicile.

***Question: Explain the difference between SAP and GAAP Accounting treatment of each of these balance sheet or income statement items***

**SAP requires creation of a liability for a portion of overdue reinsurance recoverables and reinsurance recoverables from unauthorized reinsurers, unless the recoverables are collateralized. This is called the provision for reinsurance and supports SAP’s liquidation perspective. GAAP does not have this same requirement. However, under GAAP, reinsurance recoverables deemed uncollectible must be subtracted from the reinsurance recoverables asset**.

**Policy Acquisition Costs**

***Question: Explain the difference between SAP and GAAP Accounting treatment of each of these balance sheet or income statement items***

**Under SAP, insurers are required to recognize the full amount of policy acquisition costs, including underwriting expenses, commissions, and taxes, at policy inception, even though the matching principle would require those expenses to be spread evenly over the term of the policy as the associated premium revenue is earned. Immediately recognizing policy acquisition costs while deferring recognition of the associated revenue causes surplus to decrease. This is often referred to as “a drain on policyholders’ surplus”. GAAP allows policy acquisition costs to be capitalized (an asset called “deferred policy acquisition costs” is created) and amortized over the policy’s life, correctly matching premium revenues with expenses.**

**Reporting of Subsidiaries and Affiliates**

***Question: Explain the difference between SAP and GAAP Accounting treatment of each of these balance sheet or income statement items***

**Under SAP, investments in subsidiaries, controlled, or affiliated entities (SCAs) are considered admitted assets and must be shown on the parent company’s balance sheet. Under GAAP, the financial statements of majority owned subsidiaries are consolidated into the parent company’s financial statements.**

**Pension Accounting**

***Question: Explain the difference between SAP and GAAP Accounting treatment of each of these balance sheet or income statement items***

**Under SAP, contributions made for nonvested employees under both defined benefit plans and defined contribution plans are not recognized when made and therefore are not a deductible expense on the income statement. Such contributions qualify as a prepaid expense and under SAP, a prepaid expense is a non-admitted asset because it is not readily convertible to cash. GAAP recognizes pension contributions as expenses as they are incurred for all employees, whether vested or nonvested**.

**Statement of Comprehensive income**

***Question: Explain the difference between SAP and GAAP Accounting treatment of each of these balance sheet or income statement items***

**GAAP requires a statement of comprehensive income, which shows unrealized appreciation (depreciation) of investments, foreign currency translation gains (losses), and changes in minimum pension liability, all of which are not included in the GAAP Income Statement. The statement of Comprehensive Income adds these amounts to net income to determine “comprehensive” income.**

**SAP does not require a statement of comprehensive income**. However, the capital and surplus account in the Annual Statement shows similar types of items that are not included in net income and are entered directly as an adjustment to policyholders’ surplus.

The completed chart shows the differences in SAP and GAAP reporting

|  |  |  |
| --- | --- | --- |
| **Item** | **SAP Value** | **GAP Value** |
| Admitted Assets: $1,200,000 | $1,200,000 | $2,000,000 |
| Non-admitted Assets $800,000 |  |  |
| Purchase of Bond: $1,000,000 | $900,000 | $700,000 |
| Current Market Value $700,000 |  |  |
| Current Amortized Value $900,000 |  |  |
| Total Premium Balances $2,000,000 | $1,200,000 | $1,400,000 |
| Amount deemed Uncollectible $600,000 |  | ($600,000) |
| Amount over 90 days past due $800,000 |  | *(reserve offset)* |
| Loss and LE Reserves $1,000,000 | $9,995,000 | $1,000,000 |
| Reinsurance Recoverables | assets N/C | assets $5,000 |
| (for unpaid losses and LAEs) $5,000 |  |  |
| Pension contributions made nonvested | N/C | $800,000 |
| employees for the year $800,000 |  |  |
| Total comprehensive income $3,500,000 | N/C | $3,500,000 |

**Components of the NAIC Annual Statement**

**NAIC Annual Statement: The primary financial statement prepared by insurers and required by every state insurance department**

Regulators, financial analysts, customers, and competitors use the information reported in an insurer’s National Association of Insurance Commissioners (NAIC) Annual Statement to gauge the insurer’s financial strength.

Insurers must file an NAIC Annual Statement with the insurance department of the state in which they are domiciled and, directly or through the NAIC, in every state in which they do business. Similar to financial statements prepared using generally accepted accounting principles (GAAP), the Annual Statement contains a balance sheet, an income statement, a statement of changes in capital and surplus (shareholders’ equity under GAAP), and statement of cash flows. However, the Annual Statement provides much more supporting detail than a GAAP financial statement.

**General Organization of the Annual Statement**

***Question: In general, how does an insurer’s NAIC Annual Statement differ from its generally accepted accounting principles (GAAP) financial statement***

**In an Annual Statement, detail to support the primary financial statements is provided through supplementary exhibits, schedules, notes and interrogatories.**

**Assets and Liabilities (Balance Sheet)**

***Question: Describe the components of the asset page of the NAIC balance sheet***

The balance sheet portion of the Annual Statement is a summary of the insurer’s financial position on December 31 of the calendar year. Assets are what the insurer owns, liabilities are what the insurer owes, and policyholders’ surplus is the difference between the two.

***Note that the Annual Statement refers to policyholders’ surplus (often called “surplus”) rather than the GAAP preferred term “shareholders’ equity”. This reflects the focus of statutory accounting, which reports on the insurer’s ability to meet its obligations to policyholders***.

**The asset side of the balance sheet shows both the admitted assets and non-admitted assets for each major asset class. Asset classes are organized into two broad categories: invested assets and non-invested assets. Invested assets are income producing assets such as bonds, stocks, real estate, and mortgages. Non-invested assets are those that support the generation of income but do not directly earn income, such as receivables for reinsurance and receivables for premiums**.

Loss reserve: An estimate of the amount of money the insurer expects to pay in the future for losses that have already occurred and been reported but are not yet settled.

Loss Adjustment Expense Reserves (LAE): Estimates of the future expenses that an insurer expects to incur to investigate, defend, and settle claims for losses that have already occurred.

The principal liabilities are loss reserves, loss adjustment expense reserves, and the unearned premium reserve. Reinsurance recoverables for unpaid losses and loss adjustment expenses are netted from the loss reserves and loss adjustment expense reserves. Unsecured recoverables and penalties for over-due recoverables from reinsurers are included under a liability account called “provision for reinsurance”.

Surplus can be classified into three major parts: contributed surplus, unassigned surplus, and treasury stock.

**Statement of Income**

The Statement of Income (Income Statement) measures the insurer’s earnings over the course of the year and serves as the basis for determining the insurer’s federal income tax liability. The income statement breaks down earnings into three main categories:

* Underwriting income
* Investment income
* Other income

***Question: Explain how underwriting income is measured and reported in the NAIC Statement of Income***

**Underwriting income is measured as the difference between premiums earned and losses and expenses incurred during the period. Changes in premium and loss reserves from prior years affect the current year results. Earned premium is reported on a calendar year basis and calculated as the sum of the year’s written premiums plus the unearned premium reserve at the beginning of the year, less the unearned premium reserve at the end of the year. Losses and loss adjustment expenses are also reported on a calendar year basis as the sum of losses and loss adjustment expenses paid during the year, plus ending reserves, minus beginning reserves**.

***Investment income has two components: net investment income and net realized capital gains. Net investment income is the interest, dividends, and real estate income earned on invested assets during the year minus expenses incurred in conducting investment operations. Net realized capital gains are the gains or losses realized from selling invested assets during the year***.

***Other income consists of revenues and expenses that are not related to either underwriting or investment activities. Examples include charge-offs of out-standing receivables from agents, dividends to policyholders, and finance and service charges not included in premiums***.

**Capital and Surplus Account**

***Question: What is the purpose and what are the components of the Capital Surplus Account exhibit that is included in the NAIC Statement of Income***

**The Capital and Surplus Account exhibit, which is included in these Statement of Income, provides details of changes in the policyholders’ surplus during the year. Net income directly affects the level of policyholder’s surplus. Other surplus changes flow from changes in the balance sheet accounts. The principal balance sheet related elements leading to changes in the policyholders’ surplus are changes in non-admitted assets, net unrealized capital gains, net unrealized foreign exchange capital gains, net deferred income taxes, changes in the provision for reinsurance, and contributions to and withdrawals from contributed capital accounts**.

Increases in non-admitted assets are a direct charge to surplus. For example, if a premium receivable became overdue, net admitted assets would decline by the amount of the receivable, but liabilities would remain the same. Because policyholders’ surplus is the balancing figure, it would decline by the non-admitted amount.

Unrealized capital gains or losses on invested assets occur when an asset increases or decreases in value during the year, but the asset is not sold during the year. Those changes in value are not reported in the income statement until the asset is sold. However, the statutory principle of valuing an insurer at liquidation value requires an adjustment to policyholders’ surplus to reflect the change.

Timing differences between when income tax obligations are recorded on an insurer’s books and when the tax is paid create deferred tax assets and liabilities. Deferred tax assets arise when the payments will be lower in the future, and deferred tax liabilities occur when tax payments will be higher in the future. Net deferred income tax is the difference between deferred tax assets and deferred tax liabilities, and changes in the relative balance are charged to surplus.

Contributed capital is equity capital from outside sources. A mutual insurer could issue a surplus note to raise additional capital, or stock insurer could issue additional shares of stock to new investors.

**Surplus Note: A type of unsecured debt instrument, issued only by insurers, that has characteristics of both conventional equity and debt securities and is classified as policyholders’ surplus rather than as a liability on the insurer’s statutory balance sheet**.

**Cash Flow**

***Question: Identify the three sections of the NAIC cash flow statement, and explain the general focus of each***

The purpose of the insurer’s cash flow statement is to show the actual cash, as opposed to accounting earnings, that flows through the business in the course of the year. Cash, not earnings, is what pays policyholders’ claim and underwriters’ salaries. The cash flow statement also shows whether investments as well as financing and miscellaneous sources are generating positive or negative cash flows. It is divided into three sections;

* ***Cash from Operations – This section shows the cash generated from the insurer’s core business function: selling and servicing insurance policies and earning investment income from the funds held to service the insurer’s obligations. The values reported are actual dollar flows that occur during the period*.**
* **Cash from Investment – This section shows the cash inflows and outflows from the sale and purchase of investment assets. Sales of assets increase cash, while purchases of assets decrease cash.**
* **Cash from Financing and Miscellaneous Sources – This section includes changes in borrowed funds and contributed capital**.

**Other Exhibits and Schedules**

***Question: Summarize the purpose of the Schedules D, F, and P in the NAIC annual Statement***

Several different schedules are prepared to provide details on the assets and liabilities reported on the balance sheet and the income statement. These include Schedule D which provides detail on an insurer’s investment portfolio; Schedule F, which addresses reinsurance; and Schedule P, which covers loss development.

* ***Schedule D – This schedule provides detail on an insurer’s investment portfolio and includes a series of schedules that describe an insurer’s investment in bonds, preferred stocks, and commons stocks. These are classified as detailed schedules and summary schedules*.**
* **Schedule F – This schedule addresses reinsurance. It contains nine parts that provide expanded information on an insurer’s reinsurance arrangements, including reinsurance ceded to authorized reinsurers, unauthorized reinsurers, and certified reinsurers, and the effect of those reinsurance arrangements on the insurer’s balance sheet.**
* **Schedule P – This schedule covers loss development and provides information to analyze loss reserve levels and incurred loss development. Schedule P reports losses on an accident-year basis for each of the last ten years and includes interim valuations to show how losses for each accident year have developed over time. It contains seven major sections, and sub-schedules are prepared for each of twenty-two separate lines of insurance.**

Authorized Reinsurer: A reinsurer that is authorized to do business in the primary insurer’s state of domicile.

Certified Reinsurer: An unauthorized reinsurer that meets certain qualifications and is approved by the state insurance regulator of the ceding company’s state of domicile.

Application Question:

Nancy is an experience investor in stocks and bonds of companies in several industries, but not in property and insurance. Her investment advisor has recommended she invest in Insurer XYZ to diversify her investments. Nancy has obtained XYS’s current NAIC Annual Statement to review.

Nancy likes to start her review of a company’s financial statements by determining how much shareholder’s equity the company has. However, she is unable to locate this item in XYZ’s balance sheet portion of the Annual Statement. Where is the amount listed, and why is it not labeled “shareholder’s equity”.

* The balance sheet portion of the NAIC annual Statement refers to policyholder’s surplus (often called surplus”) rather than the GAAP preferred term “shareholder’s equity” The reason for using this different term is that it reflects the focus of statutory accounting, which reports on the insurer’s ability to meet its obligation to policyholders.