GAAP for Stock Life Companies: The Issue Returns

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A single set of accounting principles now serves as the basis for stock life, property/casualty and title insurance companies.

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The abandonment of statutory accounting principles in favor of generally accepted accounting principles (GAAP) in preparing general-purpose financial statements for stock life insurance companies now is well established. Spurred on by the many adjustments being made to statutory income by financial analysts in order for them to obtain a more realistic representation of net income, accountants became active in the late 1960s in the derivation of GAAP for stock life companies. The immediate result of their efforts was the adoption of Audits of Stock Life Insurance Companies, issued in 1972 by the American Institute of Certified Public Accountants (AICPA). As responsibility for accounting standards later shifted from the AICPA to the Financial Accounting Standards Board (FASB), it was inevitable that the FASB eventually would review those standards contained in the AICPA’s Audit Guide.

The FASB’s first move in this direction was its adoption of Statement of Financial Accounting Standards (SFAS) No. 32, “Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters.”

In this pronouncement the Board established that the specialized accounting principles and practices contained in certain AICPA audit guides and statements of position were to be designated as “preferable.” Even though these “preferable” principles had not been derived through the due process procedures followed for all prior FASB standards, enterprises affected by these audit guides and statements of position were expected to follow the principles contained therein.

Since the FASB issued SFAS No. 32, the Board has been reconsidering the principles contained in all applicable industry accounting and audit guides and statements of position. Their review has not been designed to study issues which have arisen since each audit guide and statement of position was adopted.

Instead, the FASB has been examining only the propriety of the current principles, considering them within the context of existing authoritative pronouncements. After due process, the provisions of the original audit guides and statements of position have, for the most part, been reissued without change as separate Statements of Financial Accounting Standards.

The FASB completed this review of AICPA pronouncements for stock life, property/casualty and title insurance companies in June. Instead of issuing separate statements for each type of enterprise, the FASB combined the accounting principles for all of these different companies. The final product, contained in SFAS No. 60, “Accounting and Reporting by Insurance Enterprises,” was a set of accounting principles to apply to all insurance enterprises except those for which the AICPA previously had not derived principles. This unified set of principles now represents GAAP for all insurance companies, excluding mutual life insurance companies, assessment enterprises and fraternal benefit societies.

Thus a new version of GAAP has been created for stock companies. The principles contained in SFAS No. 60 do not represent a major departure from those originally established in Audits of Stock Life

(Continued)
Insurance Companies, modified by Statement of Position 79-3 ("Accounting for Investments of Stock Life Companies"). However, they will revise slightly both the GAAP financial statements and the related financial disclosures. This article summarizes the new standard, concentrating upon the method of determining which specific accounting principles apply to the various types of insurance issued by a company, and the specific changes in principles for stock life companies.

Accounting Principles

The AICPA’s original approach in establishing accounting principles for the insurance industry focused on the type of company providing insurance coverage. Separate audit guides were published for property/casualty and for stock life companies (each audit guide also was amended by Statement of Position), and a separate statement of position was issued for title insurance companies. Although some of the accounting principles defined in these pronouncements are common to all of these companies, there never was any movement by the AICPA toward defining a single set of principles to be used for all insurance enterprises.

The FASB rejected this notion that insurance accounting principles should be dependent upon the type of enterprise issuing the insurance. It instead sought to devise one set of accounting principles which could be applied to all insurance companies, regardless of the nature of the insurance protection offered by a particular company. This changed orientation meant that the type of insurance coverage no longer could serve to differentiate between potentially conflicting accounting principles. Instead, the FASB needed to select a new foundation upon which this set of accounting principles could be constructed.

The basis which the FASB selected is the time period that the insurance contract is expected to remain in force. In applying SFAS No. 60, all insurance contracts must be defined as either short or long-duration contracts. Different revenue recognition procedures (as well as certain other accounting and reporting principles) are applicable for each category of contract.

A short-duration contract is one which “provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period.” Policies which permit the insurer to adjust either the level of coverage provided or the amount of premium charged are defined as short duration contracts.

In contrast, a long-duration contract is one where the insurer generally is unable to make unilateral changes in the contract’s provisions, such as noncancellable or guaranteed renewable policies. In addition, the contract usually requires that the insurer perform various functions and services (including insurance coverage) for an extended time period.

For the most part, insurance policies issued by property/casualty companies are classified as short-duration contracts, while those issued by stock life and title insurance companies are long-duration.

However, there are notable exceptions to this generalization. Some term insurance contracts issued by stock life companies, such as credit life insurance and some single-payment or limited-payment term insurance, are classified as short-duration contracts. In addition, accident and health insurance contracts issued by stock life or property/casualty companies which are not noncancellable, guaranteed renewable or collectively renewable (within a specific group) also are defined as short-duration contracts.

Revenue Recognition

SFAS No. 60 requires that premium revenue be recognized in a manner consistent with the expected functions and services to be provided by the insurance company. Premium revenue derived from short-term contracts is to be recognized over the life of the contract (or the period of risk) in proportion to the amount of insurance coverage provided. In most cases, this means that a level amount of revenue will be recognized over the time period. In contrast, premium revenue from long-duration contracts is to be recognized when due from the policyholders.

These principles governing revenue recognition result in virtually no changes in the revenue recognition process for stock life insurance companies. The Audit Guide identified very few contracts for which revenue recognition should be in accordance with those standards set by the FASB for short-duration contracts. Those contracts included:

- Term contracts (such as credit life insurance or other single or limited-payment contracts of relatively short duration), where the principal service to be provided by the company is protection.
- Those accident and health policies not expected to be in force for a reasonable period of time.

All other types of contracts issued by stock life companies were required by the Audit Guide to recognize premiums as revenue when due; the new FASB standard does not change these practices.

The criteria used by the Audit Guide to recognize revenue centered upon the predominant functions or services required of the life company; if a policy could be identified as having a single predominant function or service feature, then the revenues should be recognized in accordance with the performance of that function or service. If there were several functions or services required (none of which was predominant), then the premium revenue was to be recognized when due. SFAS No. 60 continued with this procedure; the only difference is that an intermediate step—the classification of the policy as short- or long-duration—was inserted into the process. In both cases the expected functions and services to be provided by the insurance company govern the revenue recognition procedures to be applied to a specific type of policy.

In reviewing the accounting principles contained in the two audit guides and three statements of position and combining them into the new standard, the FASB sought to (continued on page 118)
end divergent practices within the insurance industry. As a result, "practices among insurance enterprises [which] are different without differences in circumstances" should not continue. This criteria was applied to the accounting for claim adjustment expenses.

Property/casualty companies traditionally have accrued a liability for those expenses expected to be incurred in the settlement of unpaid losses. In contrast, stock life companies have expensed all claim settlement costs as incurred. As the FASB did not find that different circumstances existed between property/casualty and stock life companies regarding this item, the Board ruled that these divergent accounting practices should not continue. Thus, stock life companies now must accrue a liability for the expected costs of settling claims unpaid at the balance sheet date. This liability represents an estimate of both external costs, such as legal fees, and internal costs to be incurred for those claims in process of settlement at year-end.

It is doubtful that significant differences in the GAAP financial statements will result from the application of this principle to stock life companies. The notable change will be in the amount reported for GAAP stockholders' equity, which will be reduced slightly as a result of recording this liability on the balance sheet. GAAP net income will be substantially unchanged, as long as liabilities of similar size are estimated at the beginning and the end of the year.

Other Accounting Principles

SFAS No. 60 addresses numerous other issues of accounting for insurance companies. Included among these areas for which principles of accounting are enumerated include liabilities for future policy benefits, acquisition costs, premium deficiencies, reinsurance transactions, retrospective and contingent commission arrangements, separate accounts, and income taxes. The conclusions reached in each of these areas are identical to those originally developed in the Audit Guide. In addition, the new statement from the FASB also prescribes the principles of valuation and income recognition to be followed in accounting for investments and real estate used in the company's business; these guidelines are identical to those contained in the AICPA's Statement of Position No. 79-3. Thus for each of the above areas the existing accounting principles continue unchanged.

Financial Accounting Disclosures

In addition to the imposition of additional requirements governing accounting for claim adjustment expenses, SFAS No. 60 also extends the disclosures contained in the footnotes to the statements. A complete comparison of those disclosures specifically demanded by the Audit Guide and SFAS No. 60 is shown in Exhibit 1 (page 120).

Policy Liabilities

From its adoption in 1972, the Audit Guide has required the disclosure of the methods and assumptions used in determining policy reserves. These disclosures will be continued under SFAS No. 60. In addition, this new statement also encourages, but does not require, disclosure of the average assumed investment yields in effect for the current year. According to the FASB, this disclosure "is useful in assessing the reasonableness of estimated rates of return in relation to current investment yields and in comparing insurance enterprises."

While the above conclusion may have merit, the statement users must recognize that the interest rate anticipated in the future is only one assumption made in determining this liability. Undue importance might be directed to this single figure. In addition, the comparison of yields assumed by different companies is beneficial only if a number of companies disclose this information. Given that this disclosure is only encouraged, there is no certainty that the second benefit mentioned by the FASB will be achieved. Only time will tell if this disclosure will provide significant information to the users of these statements.

With the emphasis the FASB assigned to this area in the development of financial accounting principles, it is predictable additional disclosures must be prepared for these items. Presumably to be contained within the footnotes disclosing the enterprise's significant accounting policies, a description of the basis used in estimating the liabilities for unpaid claims and claim adjustment expenses is to be provided.

In addition, in the narrative describing reinsurance transactions the estimated amounts recoverable from reinsurers, which will reduce each of these estimated liabilities, must be included.

Stockholders' Equity

SFAS No. 60 continues to stress the role that statutory accounting principles play in a company's operations, along with requiring selected information computed under that basis. Most disclosures required by the Audit Guide continue to be needed under the new standard. The only major change is a shift from emphasizing statutory surplus by itself to disclosing the sum of statutory capital and surplus.

Because of the significant difference between statutory accounting principles and GAAP, the Audit Guide recommended both a statutory balance sheet and a reconciliation of GAAP income and stockholders equity to comparable items computed on a statutory basis. One reason for those disclosures was to aid statement users during the transition period from statutory principles to GAAP. The FASB now believes that the need for these items no longer exists and that its other stockholders' equity disclosures provide all the necessary statutory information. Of course, if companies feel that statutory balance sheets and/or reconciliations of income and equity remain necessary, they may continue to include them in their footnotes.

Additional disclosures now are required if an insurance company (1) presents its estimated liabilities for unpaid claims and claim adjustment expenses for short-duration con-
tracts at present values, or (2) uses anticipated investment income in determining whether a premium deficiency exists on these contracts.

As short-duration contracts represent a small, if not insignificant, portion of a typical stock life company's overall business, one or both of these disclosures will be necessary only if there is a significant amount of such business. If the amount of short-duration business is immaterial, then neither of these disclosures is required.

Conclusions

The major significance of SFAS No. 60 is that separate accounting principles for different types of insurance companies are no longer appropriate. Rather, a single set of accounting principles now serves as the basis for stock life, property/casualty and title insurance companies.

In deriving this statement, the FASB has extracted the principles of accounting contained in several audit guides and statements of position, adjusting them only for inconsistencies in different insurance enterprises' accounting practices. For stock life companies, the only financial accounting change involves recording a liability for estimated claim adjustment expenses. Required disclosures for these companies also are expanded, although the presentation of certain information prepared according to statutory accounting principles has been eliminated.

SFAS No. 60 was never intended to establish a comprehensive set of accounting and reporting principles for all insurance companies. Issues relating to new types of insurance developed after the adoption of the audit guides and standards of position were deliberately not considered; neither was the question of what accounting principles should apply to mutual life, assessment and fraternal benefit companies. Ultimately, the resolution of the above issues will depend upon the results of the FASB's Conceptual Framework Project. For the time being, however, SFAS No. 60 is the authoritative source for stock life companies' financial accounting and reporting.

EXHIBIT I
Disclosure Checklist for Stock Life Insurance Companies

<table>
<thead>
<tr>
<th>Disclosure</th>
<th>Status Per Audit Guide</th>
<th>Status Per SFAS No. 60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reconciliation of net income and stockholders' equity determined under GAAP with those amounts determined under regulatory procedures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Statutory Balance Sheet</td>
<td><strong>Desirable</strong></td>
<td><strong>Not Required</strong></td>
</tr>
<tr>
<td>Income Taxes</td>
<td><strong>Desirable</strong></td>
<td><strong>Not Required</strong></td>
</tr>
<tr>
<td>Basis upon which current and deferred taxes have been provided</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>For life insurance enterprises or a parent of a life insurance enterprise that is either consolidated or accounted for by the equity method</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>(1) The treatment of policyholders' surplus under the U.S. Internal Revenue Code and that income taxes may be payable if the enterprise takes certain specified actions, which shall be appropriately described</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>(2) The accumulated amount of policyholders' surplus for which income taxes have not been accrued</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>Any retained earnings in excess of policyholders' surplus on which no current or deferred federal income tax provisions have been made and the reasons for not providing the deferred taxes</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>Unused operating loss carryforwards, including amounts and dates of expiration</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>Short-Duration Contracts:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The carrying amount of liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts that are presented at present value in the financial statements and the range of interest rates used to discount those liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Not Required</strong></td>
<td><strong>Not Required</strong></td>
<td></td>
</tr>
<tr>
<td>Whether the insurance enterprise considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Not Required</strong></td>
</tr>
</tbody>
</table>

*Accounting Principles Board Opinion No. 22, "Disclosure of Accounting Policies."
**Might be required under some state regulations

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