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Risk Management Practices and Accounting Requirements

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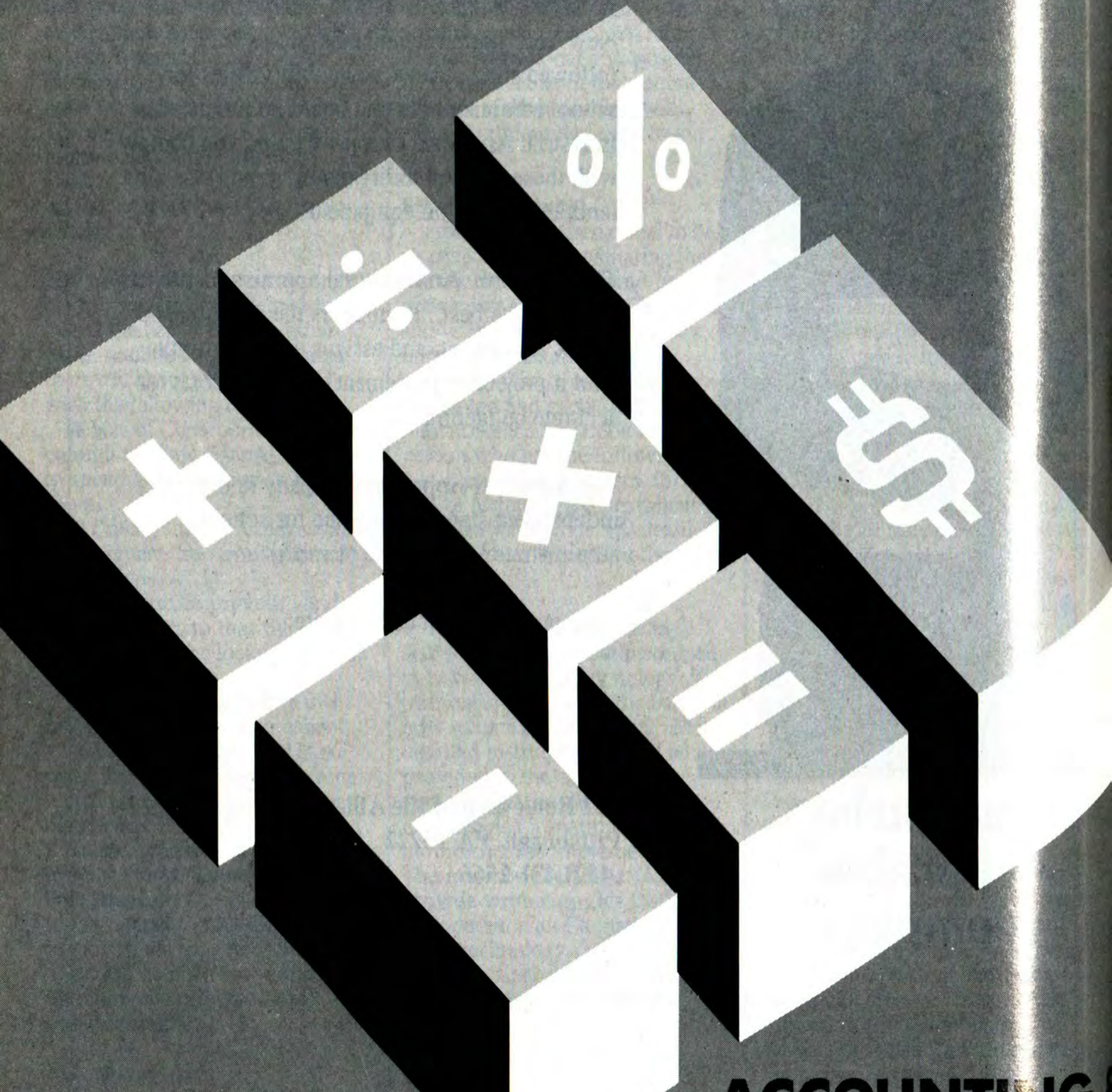

ACCOUNTING & FINANCIAL REPORTING

How much indebtedness is missing from your school district's balance sheet? How much of a burden is being shifted to future generations of taxpayers by failing to provide for these obligations in this year's budget? Both of these questions are prompted by the changing insurance environment, where skyrocketing costs of commercial insurance have forced school districts and all other governmental units to reevaluate their risk management practices. A common response has been a shift away from commercial insurance to other means of protecting against risk. To the extent that school districts assume additional risks themselves, liabilities for losses resulting from these added risks must be reported on their balance sheets.

In attempting to answer the above questions, it should be recognized that, depending on how their insurance coverage has changed, the amount of indebtedness for individual school districts may or may not be significant. However, for all school districts, the aggregate amounts are, in all likelihood, potentially staggering. The reasons for this are twofold. First, most governmental units have emphasized accounting for claims. Second, even for those units attempting to follow authoritative pronouncements, as changes in obtaining insurance coverage have developed, accounting has not kept pace with the changing insurance environment.

Since 1986 the Governmental Accounting Standards Board (GASB) has been investigating issues associated with accounting for risk management, trying to determine whether the limited guidance contained in present accounting standards should be expanded to incorporate these insurance arrangements. GASB's tentative conclusions are contained in their exposure draft, "Accounting and Financial Reporting for Risk Financing and Related Insurance Issues," [1] issued in December 1988. If these conclusions are adopted in their present form, major changes in accounting for some risk management activities will result.

Before summarizing GASB's conclusions in the exposure draft and discussing the impact of these proposed accounting standards on school districts' risk management practices and on their financial statements, this article will review current school district risk management practices and the related accounting requirements.

Present Risk Management Practices

Most businesses and governmental units attempt to find ways to reduce the amount of risk to which they are daily exposed. The process through which these entities seek either to avoid accidental loss or, when it occurs, to minimize its consequences is called risk management. Generally speaking, all entities manage risk through risk control and risk financing. Risk control refers to procedures which may be instituted to reduce exposure to risk (e.g. locking doors to prevent theft or vandalism), while risk financing refers to a conscious decision by the entity's management of whether to transfer risk to others (through insurance policies) or to retain risk internally (through what is often called self-insurance). While risk control is an essential part of risk management, this article focuses principally upon risk financing.

There are two ways by which school districts finance their risks. In general, these involve transferring risk by obtaining insurance coverage externally, either through commercial insurance companies or through risk pools with other governmental units, and retaining risk by not obtaining outside coverage for all or a portion of potential losses. These two basic alternatives—risk transfer and risk retention—are described as follows.

■ **Risk Transfer (Including Risk Pools).** Risk is transferred when a school district obtains insurance coverage from outside parties. One common practice is to purchase individual policies with insurance companies, so that the risk of loss is transferred from the school district to the insurer. While this effectively reduces risk, its major disadvantage — the increasing cost of this insurance — has led school districts to seek alternative means to finance their risks. An increasingly popular alternative to transferring risk is through joining or forming a risk pool with other governmental entities, whereby several governmental units combine their resources to provide insurance coverage. By pooling with similar units, the cost of the coverage may be substantially below the amount that would be expended for individual policies obtained from commercial insurers.

■ **Risk Retention.** This approach is often called self-insurance, whereby the district retains the risk of loss. In actuality, self-insurance represents no formal insurance coverage at all, as no risk has been transferred to outside parties. When risk is retained, the unit may either "go bare" by not funding any potential liabilities or may fund in advance at least a portion of these potential liabilities. Under the unfunded alternative, as a loss is incurred, all costs associated with that loss are to be borne by current and future periods. In contrast, if the school district provides funding for potential liabilities, the cost of some, if not all, of the loss will be covered by resources already available; resources to be generated in future periods will have to cover, at most, only a portion of the total loss. The amounts to be funded can be determined either through actuarial assumptions or by other procedures, which depending on the risks being assumed, may vary from analyzing past experience to simply designating an arbitrary amount.

Many school districts elect a combination of these two approaches. For example, most have a deductible with each insurance policy. The district retains the risk from losses up to the amount of the deductible, while risk for losses above that amount is transferred to an external insurer. Another combination involves transferring only some risks through commercial insurance policies, using insurance pools and/or self-insurance for the remaining risks.

How can school districts respond to the increasing costs of insurance? One approach is through increased emphasis on risk control. For example, some risks can be avoided if certain extra-curricular activities (e.g., football) are eliminated. Other risks, such as property losses from theft and vandalism, might be reduced if improved security systems are installed. A second method is by changes in risk financing. School districts may elect to retain additional levels of risk through larger deductibles on their commercial insurance policies, or they may elect to discontinue certain types of insurance coverage. For example, a school district may self-insure its employees' accident and health coverage, use an insurance pool for property insurance, and transfer other risks to commercial insurers rather than use commercial insurance for all risk financing.

These changes in risk financing should be accompanied by changes in budgeting for risk management. The budget for each year should provide for more than the payments to commercial insurers and risk pools. To the extent that the school district retains a greater level of risk, either through self-insurance or increased deductibles, the budget should contain provisions for all anticipated losses for which the district itself will have responsibility. Actuarial assistance might be necessary to develop estimates of these losses for which the district retains the risk, although a less formal analysis of past experience may also provide a reasonable estimate of potential losses.

Present Accounting Requirements

Currently, two pronouncements guide accounting for risk management. These are National Council on Governmental Accounting Statement No. 4 [2] (as modified by NCGA Interpretation No. 11 [3]) and SFAS No. 5. [4] The first of these focuses on accounting for those claims and judgments for which a governmental unit has some responsibility, while the latter is a broader pronouncement, emphasizing accounting for contingencies by all enterprises, both governments and private businesses. These two pronouncements do not provide authoritative support for all potential risk management activities of governmental units. Thus, one reason for the GASB's interest in these issues is to offer guidance for those risk financing activities excluded from current authoritative literature. A second reason is that present standards require only limited disclosures relating to the entity's risk management practices.

The general guidelines on recognizing losses from claims and judgments are stated in SFAS No. 5. According to that statement, a loss should be accrued when it is both probable and measurable, with the amount of the accrual depending on the amount of the risk transferred. If the risk of loss has not been transferred to an outside party, then the full amount of the loss should be accrued. If some of the risk has been transferred (for example, through an insurance policy containing a deductible), only the portion of the loss to be borne by the school district needs to be accrued. While IBNR (incurred but not reported) claims should be recorded as liabilities (at their estimated settlement value), in practice, governmental units may delay reporting the liability until a claim has been asserted.

NCGA Statement No. 4 requires this loss liability to be recognized as an expenditure when paid or expected to be paid from available expendable resources; in all likelihood, this liability would be reported in the General Fund. Additional amounts to be paid using future resources accumulations are then shown in the General Long-Term Obligations Account Group. A disadvantage of this accounting procedure is that the entire loss may not be recorded as an expenditure when the loss is incurred; instead, an expenditure is reported only as payment is made (or is expected to be made). Thus, to the extent that future resources will be required to pay for this loss, the overall effect of th loss may be understated in the eneral Fund's Statement of Reven es, Expenditures, and Change n Fund Balances for the curr t year. Similarly, if the liabil for the loss has not been finall adjudicated, this liability n ght not even be reported in the financial statements.

As noted above, the ext t that risk has been transferred t outside parties affects the ount of loss for which the schoo district is responsible. In a lition, the decision of the school trict of whether to accumulate r sources to provide for loss which may develop also h an impact. If resources are ac mu- lated prior to the losses be incurred, then the account for the loss depends on the fu used in accounting for these res rces. At the present time, many verse funds are being used; som governmental units contin to include the resources in th general fund, while others eate a separate fund, using either special revenue fund, exp able or nonexpendable trust fu or internal service fund.

NCGA Statement No. 4 lows wide variation in the choic of funds to be used in accoun g for this resource accumulation Specifically, while it permi governmental units to crea a separate Internal Service F d (or other such fund) for payin laims and judgments of all gover nen- tal funds, it neither require hat a separate fund be created n does it specify the nature of that specific fund. In addition, hen a separate fund is used, the s te- ment does not permit the i ured fund to record expenditure for any amounts remitted to th separate fund; instead, reso rces transferred to that fund up an actuarially determined leve are an operating transfer, and add ional amounts are a residual equi transfer.[5]

If a governmental entity lects not to use a separate fund w hen it does not carry insurance, it nay designate (not reserve) a po tion of fund equity as a reserve r loss contingencies. However, n losses can be charged to the amou t so designated. Instead, the los es are shown as an expenditure on y when payments are made (or expected to be made) from expendable available resources.

Currently there is no official guidance surrounding the amounts to be shown as expenditures when other types of insurance coverage exist. Normally, this is not a problem when risk is transferred to either insurance companies or a risk pool. In both cases, the amount expended for insurance is merely written off as an expenditure (or allocated over the periods benefited as a prepaid expenditure). If the loss experience is unfavorable for the insurer (either the insurance company or the risk pool), then the premiums for the next year are increased, and the district then reports increased expenditures for that subsequent year.

However, in some situations involving risk pools, risk is not actually transferred to the pool. For example, the pool may write policies which are 100 percent retrospectively rated. Premiums remitted to the pool at the start of the policy year might be viewed only as deposits; based on the year's experience, either a full or partial refund of this premium would be issued or additional amounts would later be contributed to cover the deficiency. This situation raises serious questions about the proper accounting for this insurance arrangement. Is the school district actually acting as an insurance company for itself? If so, should the accounting for the risks it chooses to retain parallel the accounting required of commercial insurance companies (or of public entity risk pools)?

With regard to risk pools, it should be noted that there are no formal accounting standards detailing the accounting procedures to be followed when they prepare statements. Thus, school district personnel wishing to evaluate financial statements of a risk pool, to which they either belong or are considering joining, often find that financial statements are either nonexistent or are prepared in a manner which makes it difficult to determine their true financial position and results of operation, such as when the pools use the cash basis of accounting.

Proposed Accounting Requirements

GASB's exposure draft, which arose in response to the general lack of consistency in accounting for and reporting of governmental risk financing and related insurance transactions, proposes accounting standards for risk financing and insurance-related activities for all state and local governmental entities, including public entity risk pools and other governmental organizations. The risks of losses within the scope of this proposed statement include potential losses arising from the commission of torts; theft, damage, or destruction of assets; interruption of business; errors or omissions; employees' injuries; and acts of God, as well as accident and health, dental, and other employee medical plans that may or may not be covered by insurance contracts.[6]

Entities Other Than Risk Pools

In considering the alternatives for recognizing and measuring expenditures/expenses and liabilities resulting from risk financing for entities other than pools, GASB noted that how risk is financed has significant financial and public policy implications that impact on the notion of interperiod equity, the subject of the second question posed at the start of this article.[7]

When risk of loss is transferred to a third party, cash disbursements are typically required (a) at the time of transfer and (b) through a series of level insurance premium payments over the period of time risk is financed. When risk is retained, however, there are no cash disbursements for insurance, no leveling of premiums to "cushion against catastrophic events or year-to-year fluctuations in the severity of claims."[8] In its deliberations, GASB was concerned that the fluctuations that arise from recognizing and measuring claims expenditures/expenses solely on the basis of the incurrence of events giving rise to claims might distort the measurement of interperiod equity.

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General Accounting Provisions

GASB's conclusion in this area was that state and local governmental entities, other than public entity risk pools, who have not transferred risk of loss to an unrelated third party, would be required to report an estimated loss from a contingency as an expenditure/expense and as a liability if a claim is asserted and reasonably estimated.[9] In addition, in situations where incidents have occurred before the financial statement date, but no claim has been asserted, the exposure draft requires recognition of a liability if the two SFAS 5 criteria are met: (1) if it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and (2) the amount of the loss can be reasonably estimated.

The proposed standard allows liabilities to be estimated through a case-by-case review of all claims, the application of historical experience to the outstanding claims, or a combination of these methods. As noted shortly, actuarial analysis is also permitted in some instances. Claims liabilities may be presented either at the full amount of future cash payments or at their estimated present value; in the latter case, the entity should use a discounting rate determined after considering such factors as the entity's settlement rate for those liabilities and its investment rate. Discounting is required, however, if the liability represents a contractual obligation to pay money on fixed dates.

In those instances when a governmental entity contracts with other entities to service uninsured claims, there is no transfer of risk to a pool or an independent third party. Therefore, payments to the third party should be treated as deposits or reductions of the claims liability.

Fund Type

If a single fund is used to account for risk financing activities, that fund should be either the general fund or an internal service fund. The use of a legally restricted trust fund was considered inappropriate by GASB because of the absence of a trust relationship. GASB indicated that the use of an internal service fund was appropriate in most instances because of the perceived benefit of being able to more easily review and evaluate the risk financing function. However, in accordance with their objective of minimizing the number of funds used by governmental units, GASB also permitted the use of the general fund.

General Fund

When a general fund is used, both expenditures and liabilities must be reported in accordance with the SFAS No. 5 guidelines enumerated above. The use of the general fund may be appropriate for small government entities that do not have numerous funds. Accounting for risk financing is, in this case, included with the accounting for other activities in the general fund.

An additional consideration for governmental entities using the general fund is the effect of the proposed provisions of GASB's December 1987 Exposure Draft "Measurement Focus and Basis of Accounting -- Governmental Funds (MFBA)." If the tentative conclusions of the MFBA exposure draft are adopted, the standards established in NCGA Statement 4 for governmental funds would be fundamentally altered. Subject to the transitional requirements in a final MFBA Statement, the entire estimated loss computed in accordance with SFAS No. 5 would be reported as a general fund liability; none would be shown in the General Long Term Obligations Account Group.[10]

Internal Service Fund

When an internal service fund is used, the accounting is more complex:

■ Liabilities from claims must be reported in accordance with SFAS No. 5 requirements.

■ Charges to other funds should be recognized as revenues by the internal service fund and as expenditures/expense by the other funds of the entity.

■ Expenditure can be reported using either SFAS No. 5 criteria or an optional method.

If the original change ... the internal service fund wa... not intended to recover the f... l cost of claims over a reasonable ...eriod of time, the deficit balance ...ould be charged back to the othe... funds, being recorded by the in... rnal service fund as a revenu... and by the other funds as an ex... ndi-ture/expense. A surplu... nternal service fund balance gre... er than that determined using t... optional method (described in th... next paragraph) should be ch... ged back to the other funds ... an interfund transfer.

The internal service f... d is also authorized to use an op... nal method to determine th... harges to the other funds. This ...ethod, designed to help achiev... nter-period equity, uses an a... arial funding method to dete... ine level annual charges; th... remium thus calculated may als... nclude an additional amount f... expected future catastrophe losse... so that costs associated with th... major losses would be spread ... t over several years. This met... d requires adjustments ov... a reasonable period of tin... so that revenues and expenses ... the internal service fund ar... pproxi-mately equal. A deficit ... the internal service fund ne... not be charged back to the oth... funds in any one year, but must ... dis-closed in the notes to th... inancial statements. Any surplu... und balance in the internal s... vice fund should be reporte... s equity designated for future ca... strophe losses.

Disclosures

Disclosures in the no... to the financial statements sho... d always include (1) a des... iption of the risks of loss to whic... he entity is exposed and the way... in which those risks of loss ... re handled (e.g., commerci... insur-ance, participation in a r... k pool, risk retention), and (2) a ... escrip-tion of significant reduct... ons in insurance coverage from the prior year. In addition, if the ... ntity participates in a risk po... , the footnote should also inc... de a description of the rights ... nd responsibilities of the en... ity and the pool.

If an entity retains the risk of loss, the basis for estimating the liabilities for unpaid claims, the carrying amount of the liabilities that are presented at present value in the financial statements, the aggregate outstanding amount of contingent liabilities for which annuity contracts have been purchased in the claimants' names and for which related liabilities have been removed from the balance sheet, and a reconciliation of changes in the aggregate liabilities for claims for the current year and the prior year must be disclosed. In addition, disclosure should be made for any loss contingency when there is at least a reasonable possibility that a loss or an additional loss may have been incurred and for events that occur subsequent to the date of the financial statements but before the date of issue. In accordance with SFAS No. 5, such disclosure should indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made.

Public Entity Risk Pools

The proposed standard also addresses the accounting and financial reporting requirements of public entity risk pools. The exposure draft distinguishes between pools in which there is some transfer or pooling of risk and pools not involving transfer or pooling of risk.

GASB has identified the primary users of external public entity risk pool financial reports as pool participants and those considering pool participation, legislative and oversight bodies, reinsurers, and investors and creditors. Because many public entity risk pools provide services that pool participants may have previously purchased from commercial insurance companies and compete against commercial insurers in the reinsurance and capital markets, GASB believes that consistent accounting and financial reporting standards for all insurance activities is prudent. The proposed standard requires public entity risk pools in which there is some transfer of risk to follow the current accounting and financial reporting standards for similar business enterprises, as set forth primarily in SFAS No. 60, "Accounting and Reporting by Insurance Enterprises."[11] GASB concluded, however, that pools that function only as claims servicers, not as an insurer, should only report administrative costs and related claims servicing revenues.

Effective Date and Transition Method

If this exposure draft is adopted without significant change, the new standards will be applied to financial statements for all risk pools for fiscal periods beginning after June 15, 1990, although earlier application is encouraged. Thus, risk pools will have to prepare financial statements which are based upon the same accounting principles that commercial insurance companies follow. Consequently, those school districts who have had difficulty obtaining meaningful financial statements from their risk pools should be able to do so in the near future.

The requirement for all other entities will be effective on the same date that GASB's final statement on "Measurement Focus and Basis of Accounting for Governmental Funds" becomes effective (presently anticipated to occur after fiscal 1993). Transition procedures for implementing the Risk Financing Standard will be based on those developed for the MFBA Statement.

Additional Implications for School Districts

School districts have adopted varied risk management policies in response to the increasing costs of insurance. The vagaries of the market will continue to dictate district practice, the required accounting standards will only define and classify an entity's risk financing activities. The proposed changes to accounting and financial reporting for risk management practices as outlined in GASB's exposure draft will not impact significantly on school districts when risk is transferred, either to a risk pool or third-party commercial insurance company. However, when risk is retained, there are major implications for the accounting and financial reporting of insurance-related activities. GASB's conclusion that guidance contained in SFAS No. 5 is appropriate for governmental entities and the proposed disclosure of incurred but not reported (IBNR) claims will require management to look more closely at the impact of risk financing on the fund balance.

School districts will have a choice of using either a general fund or an internal service fund. Many districts, wanting to keep the number of funds they use at a minimum, may elect to use the general fund for their insurance activities. However, when the general fund is used, GASB's MFBA exposure draft will require the full liability, including IBNR claims, to be reported in the general fund, thereby substantially reducing that fund balance. If the internal service fund is used, there will be the added benefit of disclosing all risk financing functions in one dedicated fund. In addition, if the optional method of determining interfund premiums is chosen, there is the potential advantage of achieving interperiod equity. The classification of all interfund charges as revenues and expenditures/expenses is consistent with the internal service fund assuming some characteristics of a third-party insurer for the entity's other funds.

Thus, it is important that school districts begin to plan for the consequences of this proposed standard. There are four basic consequences: (1) School districts may no longer use trust funds for risk financing and insurance related activities; either the general fund or internal service fund must be used if all risk financing activities are reported in a single fund; (2) In school districts that retain risk of loss, a potentially significant liability will be reported in the general fund or internal service fund, resulting in a reduction of the size of the fund balance; (3) In districts that transfer risk, whether to public entity risk pools or commercial insurance carriers, accounting for insurance activities will be basically unchanged; (4) however, regardless of what choices are made for accounting for risk financing, required disclosure will be significantly expanded. In all cases, disclosure will become more complex, requiring additional detailed record-keeping and including additional estimates in valuing properly the resultant expenditures and liabilities.

In summary, GASB has appropriately responded to the financial reporting implications of the changes in management practices caused by the difficult insurance market. Additional disclosures are necessary because of the potential magnitude of risk financing and related insurance transactions on the school district's financial statements taken as a whole and because of the changing nature of risk financing and the potential for liabili in an increasingly litigious societ The proposed standards for ris pool accounting and disclosure ill allow school districts to be er assess risk pool performan and financial status vis-a-vis co mercial insurance. Consistenc nd improved comparability w lead to better decisions regardi public entity risk pools by th prospective and current sc ol district participants.❑

Selected References

[1] Governmental Accountin Standards Board, *Accounting a Financial Reporting for Risk nancing and Related Insurance Is s* (Exposure Draft). Norwal CT, December 6, 1988.

[2] National Council on Gov nmental Accounting, *Accountin d Financial Reporting for Clai and Judgments and Compensate Absenses* (Statement No. 4) Chicago, August 1984.

[3] National Council on Gov nmental Accounting, *Claims an dgment Transactions for Gove ent Funds* (Interpretation No.). Chicago, August 1984.

[4] Financial Accounting Sta ards Board, *Accounting for Con gencies* (Statement No. 5). Stamf CT, March, 1975.

[5] Generally, payments fro governmental fund to an ernal service fund are an expen ure, not an operating transfer. onsequently, NCGA Interpreta n No. 11 was issued to delay the ffective date of this provision; e interpretation allows the u of an operating transfer, but it d s not require that such a transfe f resources be so classified.

[6] Governmental Accountin Standards Board, *Accounti and Financial Reporting for Risk inancing and Related Insurance Is es* (Exposure Draft). Norwal CT, December 6, 1988.

[7] Interperiod equity is defi ed as "the measure of the extent o which current-year revenu s are sufficient to pay for the ser ices provided by the governme tal

entity during the year, and whether current-year citizens are receiving services by shifting part of the payment burden to future years' citizens or by using up previously accumulated resources," Governmental Accounting Standards Board, *Measurement Focus and Basis of Accounting - Governmental Funds (MFBA)* (Exposure Draft). Norwalk, CT, December, 1988.

8 Governmental Accounting Standards Board, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues* (Exposure Draft). Norwalk, CT, December 6, 1988.

9 These accounting and reporting requirements are generally those of SFAS No. 5, *Accounting for Contingencies.*

10 The issue of the distinction between the fund liability and the general long-term debt account group (GLTDAG) is addressed in the MFBA ED, 1987.

11 Financial Accounting Standards Board, *Accounting and Reporting by Insurance Enterprises* (Statement No. 60). Stamford, CT, June, 1982.

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