



SOCIETY OF FINANCIAL EXAMINERS™

Supplemental Background Material

NAIC Examiner Project

CFE 2

Analysis & Evaluation Procedures

(Passing grade for this exam is 66)

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Chapter: One

Topic: Evolution of Insurance Accounting and Regulation

Objectives: Understand the evolution of insurance and regulation and its impact on insurance accounting.

I. Origins of Insurance Accounting and Regulation

A. Italy

1. Early forms of marine insurance
2. Protected hulls and cargo

B. England

1. Marine insurance also
2. Society met at Lloyd's Coffee House - became known as Lloyd's of London
3. Great Fire of London of 1666 demonstrated need for fire insurance
 - a. Joint stock company formed - known as Fire Office
 - b. Responded to fires of members

C. America

1. 1736 - Franklin organized Union Fire Company
 - a. Volunteer fire-fighting unit
2. 1752 - Philadelphia contributorship for the insurance of houses from Loss by Fire
 - a. Property inspected and rated
 - b. Policies written for 7 years
 - c. Individual account kept for each policyholder
 - d. By 1763, interest pooled for payment of losses
3. Fire insurance rapidly grew
4. 1850 - Accident and health coverage
 - a. Franklin Health Insurance Company of Massachusetts
 - b. Wrote accident insurance on travelers

II. Early Regulation

A. State regulation

1. After 1792, chartered by states
2. Idea of NAIC, 1828 in New York
 - a. Annual statement required of all "monied" companies
3. 1853, New York law
 - a. All companies incorporated in state to file prescribed report
 - b. Authorized comptroller to examine any insurance company doing business in state

4. 1860, New York State Insurance Department
 - a. Replaced comptroller
 - b. Power to prescribe annual report form
 5. By 1870, many states appointed state official to oversee insurance
 6. Powers of state to regulate insurance
 - a. Established in 1869
 - b. *Paul v. Virginia*
- B. Influence of NAIC
1. Early convention statement blanks
 - a. Permanent committee on blanks
 - b. Emphasis on balance sheet
 - c. Certain assets of doubtful value nonadmitted
 - d. Adjustments permitted for accruals
 - e. No distinction between long and short-term assets and liabilities
 - f. Assets: stock and bond valuation, 1906 - Committee on Assets of Insurance Companies, 1907 Committee on Valuation of Securities, publishes year-end values and basis on which bonds are to be allowed valuation at amortized values
 - g. Liabilities: Statutory loss reserves, Initially required only to recognize estimated losses on reported cases and unearned premiums, 1901, Michigan required minimum loss reserve
 - h. Expenses and rates
 2. Uniform accounting
 - a. 1948, Uniform Accounting Committee adopted uniform cost accounting standards
 3. Multiple-line blank
 - a. 1950, multiple-line blank for fire and casualty
 - b. Expenses divided into functions of claims, underwriting, and investment
 - c. Statement of Income divisions for underwriting, investment, and miscellaneous income

III. Current Regulation

- A. The States and NAIC
 1. FAIR Plans
 2. NAIC zone examinations
 3. Solvency agenda
 4. Financial Regulation Standards and Accreditation Program
 5. Codification
 6. Statements of Statutory Accounting Practice
- B. The federal government
- C. Professional accounting rule making bodies.

1. AICPA issues audit guides
 2. FASB issued statement recognizing income over policy term and capitalization of acquisition expenses
- C. Industry Changes
1. Forms of coverage
 2. Reinsurance
 3. Rating bureaus
 4. Consumer issues
 5. Health care reform

IV. Purpose of Annual Statement Reporting

- A. Provide insurance departments with information to carry out responsibility of solvency regulation.
- B. Statutory Accounting Practices
- C. Generally Accepted Accounting Principles

V. Statement Reporting Requirements

- A. Responsibility
 1. Blanks Task Force
 2. Accounting Practices and Procedures Task Force
 3. Valuation of Securities Task Force
 4. Barcoding
- B. Title Page with Jurat
- C. Financial statements and notes
 1. Balance sheet
 2. Statement of income
 3. Statement of cash flow
- D. Exhibits and schedules
 1. Detailed supporting information
- E. Interrogatories
 1. Ascertain compliance with laws and regulations
 2. Disclose specific information not obtainable from statements
- F. Statement of actuarial opinion
- G. Other schedules
 1. Schedule E
 2. Schedule Y

VI. Annual Statement Supplements

- A. Insurance Expense Exhibit
- B. Ten other supplements

VII. Statement Uses

- A. NAIC Insurance Regulatory Information System (IRIS)
- B. Risk-based capital.

- C. Desk audits
- D. Verify compliance with insurance laws and regulations
- E. NAIC profitability reports
- F. Federal income taxes computed on basis of underwriting and investment exhibits
- G. Other uses

VIII. Combined Annual Statement

- A. Required of affiliated property-liability insurers

IX. NAIC Quarterly Statements

X. Other Reporting Requirements

- A. Filing requirements
 - 1. In all jurisdictions licensed
- B. Penalties
- C. Mandatory CPA audits.
- D. Financial condition examinations and market condition examinations
- E. Statistical reports of premiums and losses

Chapter: Two

Topic: Assets

Objectives: To identify and describe admitted and nonadmitted assets.

I. Admitted assets

- A. Bonds
 - 1. Acknowledgment of indebtedness
 - 2. Recorded at cost
 - 3. Amortization
 - a. Interest method - constant yield
 - 4. Bonds designated #3 or better carried at amortized cost.
 - 5. Impairment
- B. Stocks
 - 1. NAIC designation
 - 2. Restrictions on amount invested.
 - 3. Recorded at cost
- C. Mortgage loans on real estate
 - 1. Restricted by statute and state regulation
 - 2. Initial value is principal amount of mortgage
 - 3. Asset reduced by period repaid principal
 - 4. If default, unpaid principal is nonadmitted asset
- D. Real estate
 - 1. Includes both occupied properties and income producing
 - 2. Carried at cost less encumbrances
 - 3. If market below cost
 - a. Market shown as admitted
 - b. Write down asset and recognize impairment loss.
- E. Cash and Short-term Investments
 - 1. Cash equivalents – highly liquid
 - 2. Short-term investments – maturities at time of acquisition are one year or less
- F. Other invested assets
- G. Receivable for Securities
- H. Agents' balances
 - 1. Admitted if balances due ninety days or less

2. Three parts
 - a. In course of collection
 - b. Booked but deferred and not yet due
 - c. Accrued retrospective premiums
 3. Recorded net of commission
 4. Monthly report called "account current"
- I. Funds held by or deposited with reinsurance companies
1. Company has assumed reinsurance on which it is owed funds
 2. Funds develop from two conditions
 - a. Ceding company renders accounting and withholds portion of balance due equal to unearned premium and outstanding loss
 - b. Ceding company may call for advance for payment of losses
 3. Admissibility
 - a. Funds held by ceding company is equal to or less than unearned premium and outstanding losses
 - b. Ceding company is solvent
- J. Bills receivable taken for premiums
1. Promissory note from insured
 2. Admissible if note less than premium and payable in less than full term of policy
 3. Considerations permitting acceptance
- K. Amounts Billed and Receivable under ASO Plans.
- L. Reinsurance recoverable
1. Loss reserve on which there is applicable reinsurance
 2. Asset established when claim settled and reinsurance recoverable is finalized
- M. Federal income tax recoverable
- N. Guaranty Funds Receivable
- O. Electronic data processing equipment
1. Only fixed asset aside from real estate admitted
 2. May include operating system software
 3. No other software
- P. Interest, dividends, and real estate income due and accrued
1. Traceable to Underwriting and Investment Exhibit and various schedules
- Q. Net Adjustments – Foreign Exchange Rates
- R. Receivable from parent, subsidiaries, and affiliates

- S. Amount Due from/to Protected Cells
- T. Equities and deposits in pools and associations

- U. Amounts receivable relating to uninsured accident and health plans

- V. Details of write-ins for entries not appropriate for preprinted line

II. Nonadmitted assets

- A. Bills receivable not taken for premiums
- B. Furniture, Equipment, and Supplies
 - 1. Because of limited liquidity
 - 2. Values can be substantial
 - 3. Statutory accounting
- C. Leasehold Improvements
- D. Loans on personal security or Company Stock
- E. Aggregate Write-Ins

Chapter: Three

Topic: Estimating Losses and Loss Expenses

Objectives: To identify and describe the process and methods of estimating loss and loss adjustment expenses.

I. Background

A. Importance

1. Loss and loss adjustment expense liabilities as much as half of liabilities and surplus
2. Need for accuracy evident
 - a. Fair balance sheet
 - b. Adequate pricing
 - c. Monitor return on equity

B. Structure

1. Creating a claim
 - a. Insured incurs loss
 - b. Obligation occurs immediately
2. Reporting a claim
 - a. Create claim file
 - b. Record on books
 - c. Adjuster established estimate
3. Adjusting and reserving
4. Closing a claim
5. Claims inventory

C. Definitions used

1. Dates
 - a. Accounting date - date used to define claims included in liability
 - b. Valuation date - cut-off date used in estimation of loss
 - c. Accident date - date a covered event occurs
 - d. Report date - date informed of claim
 - e. Record date - date loss entered in statistical record
 - f. Transaction date - date of a financial transaction
 - g. Settlement date - date claim is closed
2. Loss reserves
 - a. Case reserve - total of individual estimates
 - b. Supplemental reserve - addition to case reserve typically accumulated on aggregate basis
 - c. Reopened claim reserve
 - d. IBNR reserve - estimated liability for claims unreported by accounting

- date
 - e. CIT reserve - estimated liability for claims reported but not yet recorded
 - 3. Loss adjustment expense reserve
 - a. Allocated loss adjustment expense reserve - estimated liability for adjusting expenses assigned to individual claims
 - b. Unallocated loss adjustment expense reserve - estimated liability for adjusting expenses unassigned to individual claims
 - 4. Alternative names
 - a. Carried reserve - amount recorded in published financial statements
 - b. Indicated reserve - estimated liability resulting from application of particular reserving procedure
 - c. Formula reserve - for some types an individual case reserve using a formula
- D. Basic principles of a sound reserve
- 1. Sound estimate of loss or loss adjustment expense
 - a. Provision for unpaid amount required to settle claims
 - b. For a defined group of claims
 - c. As of a particular valuation date
 - d. Liability that existed on a particular accounting date
 - e. Arises from reasonable assumptions and appropriate actuarial methods
 - 2. True liability falls within a range of the estimate

II. Considerations and investigations in estimating

- A. Evaluating the book of business
 - 1. Exposure basis - the amounts of risk in a book of business
 - 2. Frequency and severity of loss
 - a. Frequency is number of claims divided by number of exposures
 - b. Severity is average loss per claim
 - 3. Homogeneity - methods of predicting improve when homogeneous
 - 4. Credibility
 - a. Measure of predictive value
 - b. Increased with homogeneous blocks
 - 5. Policy limits and deductibles
 - 6. Reinsurance treaties
 - 7. Coverage type
 - a. Occurrence policies
 - b. Claims made policies
 - c. Market or sources of business
 - 8. Line of business
 - 9. Geography
 - 10. Underwriting policy and administration
 - 11. Pools, Associations, and MGAs
 - 12. Competition and the underwriting cycle
- B. Reviewing the claim reserving and claim settlement process
 - 1. Emergence patterns (reporting delay) can vary with line and procedures

2. Fast track procedures
 3. Precautionary notice use changes will change meaning of transaction data
 4. Agent pay program changes will change emergence patterns
 5. Catastrophe procedures
 6. Settlement pattern changes will change size and importance of supplemental reserve
 7. First party versus third party claim mix changes will alter reserves
 8. Litigated versus non-litigated claims
 9. Large versus small claims
 10. Subrogation, salvage and collateral sources
 11. Confirming coverage
 12. Reopened claim potential
 13. Work loads and authority levels
 14. Development patterns
 15. Case reserving
 16. Periodic payment cases
 17. Reinsurance
 18. Partial payments
- C. Reviewing the information processing system
1. Models assume stable patterns
 2. Analyst must understand operations
 3. System interactions
 4. Data definitions
 5. Data accuracy
 6. Data completeness
 7. Data timeliness
 8. Data capture
 9. Systems development
 10. Data reconciliation
- D. Evaluating the external environment
1. Inflation
 2. Market conditions - capacity and pricing cycles cause changes in mix of business
 3. Investments - more willingness to write marginal business with good investment income
 4. Legislative activities can affect claim frequency and severity
 5. Court judgments have changed traditional interpretations of policy language
 6. Social inflation
 7. Catastrophes invalidate assumption that accidents happen independently of each other
 8. Seasonal patterns
 9. Environmental claims

III. Data organization

- A. File organization - most valuable resource is historical records
 - 1. Premium and exposure files potentially carry largest volume of data
 - 2. Loss and claim count files
 - 3. Data must be readily available and easily manipulated
- B. Run-off triangle
 - 1. General format
 - a. Entries along row are for same year of origin
 - b. Entries along column are for same development period
 - 2. Incremental triangle columns show only incremental change
- C. Types of origin periods in run-off triangles
 - 1. Accident period triangles group claims by date of loss as origin periods
 - 2. Report period triangles group claims by date claims were reported
 - 3. Policy period triangles group claims by effective date of policy
 - 4. Contract period triangles organize origin period to period contract was in force
- D. Types of data elements in run-off triangles
 - 1. Dollars
 - 2. Claim counts
 - 3. Ratios

IV. Process for estimating

- A. Amount of loss is function of factors that operate in four time frames
 - 1. Factors operating at time of origin
 - 2. Factors operating along development period
 - 3. Factors that operate both through origin and development period
 - 4. Calendar period
- B. Choosing a loss liability model
 - 1. Reviewing the insurer's operations for stability
 - 2. Define the purpose
 - 3. Organizing the data
 - 4. Ideal model one with fewest parameters that consider all material changes in operations
- C. Documenting, testing, and evaluating liability levels
 - 1. Outlining the assumptions
 - 2. Testing the system
 - 3. Documenting the evaluation

V. Annual Statement Schedule P

- A. Contains supporting details of liabilities on page 3 of Annual Statement
- B. Expansion of Schedule P effective in 1989 most significant reporting change to statistical statements since 1969
- C. General structure
 - 1. Part 1 reflects direct and assumed business
 - 2. Part 2 displays net losses and allocated loss expenses incurred, includes nine years of development
 - 3. Part 3 reflects net paid losses and allocated loss expenses
 - 4. Part 4 shows the bulk and IBNR portion of incurred losses

5. Part 5 shows claims count histories
6. Part 6 shows earned premiums on a coverage year basis
7. Part 7 provides information needed to calculate RBC
8. Interrogatories
9. Actuarial opinion

VI. Examples of simple models for estimating

- A. Grossing up method
 1. Assumes losses and claims are reported and settled at predictable rates
 2. Uses losses and claims already recorded to estimate losses and claims yet to be recorded
- B. Link ratio method (loss development factor method)
 1. Assumes recorded amounts grow in a stable manner
 2. Uses growth rates to project final values
- C. Exposure method
 1. Estimated as a function of exposures
 2. Provides an estimate of relationship between exposures and losses for last origin period
- D. Bornhuetter/Ferguson method
 1. Hybrid method
 2. Blends exposure and link ratio methods

Property-Casualty Insurance Accounting, ISAS, Eighth Edition, 2003

Chapter: Four

Topic: Earned and Unearned Premiums

Objectives: To differentiate between earned and unearned premium and describe its determination.

I. Characteristics

- A. Importance of unearned premium
 - 1. Recognition of revenue over period policy in force
 - 2. Laws require a reserve liability
- B. Written premiums - amount charged to insureds
- C. Direct written premiums arise from policies issued directly by primary company
- D. Ceded reinsurance premiums arise from policies transferred to another company
- E. Assumed reinsurance premiums arise from policies accepted from another company
- F. Gross written premiums are direct written plus assumed
- G. Net written premiums are direct written premiums plus assumed reinsurance premiums minus ceded reinsurance
- H. Earned premium is portion of premium applicable to expired period of policy
- I. In-force policies are in effect on a certain date

II. Purposes of Unearned Premium Reserve

- A. Government requirements
 - 1. 1848, New York required insurers to carry a liability equal to amount needed to reinsure all outstanding risks
 - 2. Present New York statute clearly sets forth requirement for unearned premium reserve
- B. Refund premiums
- C. Reserve for future losses
- D. Purchase reinsurance
- E. Recognize revenue

III. Computation

- A. Pro rata methods
 - 1. Monthly – divides the year into 24 equal parts
 - a. Gives reasonable reserve
 - b. Year divided into 24 equal parts
 - c. Example for policy expiring next year
 - January unearned premium factor $1/24$

- February unearned premium factor $3/24$
- 2. Daily

B. Other methods

- 1. Rule of 78's or sum-of-digits used primarily in credit insurance
 - a. Where risk exposure increases during policy period use Rule of 78
 - b. Example - Rule of 78
- Month 1 unearned factor $12/78$
- Month 2 unearned factor $11/78$
- 2. Ocean marine cargo premium earned when voyage complete
- 3. Surety bond premiums earned over term of bond

IV. Configuration techniques

A. One-year, fixed premiums

- 1. In-force
 - a. Full term premium for each policy not expired
 - b. Change computed as if it occurred at beginning of policy period
 - c. Determination of premiums in force at end of any accounting period
- 2. Direct
 - a. Amortization uses premiums written
 - b. Change treated as a transaction
- 3. Differences between in force and direct
- 4. Use of computers allows accurate calculation without determining in force

B. Other types of premiums

- 1. Audit premiums
 - a. Estimated premium used to establish in force
 - b. Additional premium earned in period adjusted
- 2. Policy cancellations remove entire premium from in force
- 3. Endorsements-additional or return premiums
- 4. Retrospectively rated policies
 - a. Require deposit premiums
 - b. Subject to retroactive adjustment
 - c. Inventory method calculates retrospective premium reserve for each individual risk
 - d. Projection method compares prior retrospective premium adjustments with prior earned premiums

V. Tests for accuracy

- A. When written premiums are fairly constant, earned premiums and in-force premiums should remain fairly constant
- B. When written premiums are growing at a steady rate, ratio of premiums earned to premiums written should be fairly constant
- C. Audit premiums and retrospectively rated premiums can have an impact on the comparison of net written premium to earned premium
- D. When new policies are for shorter periods, the unearned premium reserve can be

- significantly decreased
- E. A book of business should be analyzed to recognize variations that may influence changes in the unearned premium reserve

Chapter: Five

Topic: Other Liabilities, Capital and Surplus

Objectives: To describe Other Liabilities, capital, and surplus items.

I. Other liabilities

- A. Accounts payable and accrued liabilities
 - 1. Postretirement benefits other than pensions
 - 2. Contingent commissions
 - a. Agents and general agents
 - b. Reinsurance commission
 - Based on costs and sometimes also loss experience
 - Expense for reinsurer; reduction of expense for ceding company
 - Three types: straight profit, sliding scale, guaranteed profit
 - c. Company officers contingent commission
 - 3. Other expenses (excluding taxes, licenses and fees)
 - 4. Payables to parent, subsidiaries and affiliates
 - 5. Payable for securities
 - 6. Details of write-ins
 - B. Banking items
 - 1. Borrowed money includes loans except those secured by mortgages and surplus loans
 - 2. Accrued interest
 - 3. Debt obligations of ESOP
 - 4. Drafts outstanding
 - 5. Reserves for uncashed checks reflects liabilities under escheat laws
 - 6. Bank overdrafts
 - C. Reinsurance items
 - 1. Funds held by company under reinsurance treaties
 - a. Amounts received for payment of reinsurer's obligations
 - b. Contract should stipulate application of funds
 - 2. Provision for reinsurance
 - 3. Ceded reinsurance balances payable - net premium balances due to reinsurers
 - D. Dividends declared and unpaid
 - 1. Stockholders
 - 2. Policyholders

- E. Miscellaneous items
 - 1. Amounts withheld or retained by company for accounts of others, primarily amounts withheld from employees or agents
 - 2. Net adjustments in assets and liabilities due to foreign exchange rates
 - 3. Liability for amounts held under uninsured accident and health plans
 - 4. Aggregate write-ins, used for liabilities required by law or desired by management on a one-time or as-needed basis

II. Capital and surplus

- A. Origin of policyholder surplus
 - 1. Initial financing
 - a. Minimum capital or surplus depends on type of business and lines of insurance
 - b. Stock companies financed initially by sale of stock
 - c. Mutual companies original net worth consists of surplus paid in by original policyholders or interested parties
 - d. Reciprocal
 - 2. Ongoing financial requirements
 - a. Ongoing minimum is customarily less than initial
 - b. Treasury stock - issued, fully-paid, reacquired
 - c. Guaranty fund certificates - borrowed surplus
 - d. Capital or surplus impairment - varies by state
- B. Capital and surplus account
 - 1. Corresponds to statement of retained earnings
 - 2. Form and computation
- C. Segregating and replenishing surplus
 - 1. Special surplus funds - restrict amount available for dividends
 - 2. Subordinated surplus debentures - amounts borrowed to meet minimum surplus obligations
 - 3. Capital Notes

Chapter: Six

Topic: Written Premiums

Objectives: To describe written premiums and the accounting for written premiums.

I. Recording

A. Methods

1. Revolutionized by computer technology
2. With well controlled facility, control totals generated and used for journal entries
3. With fully integrated system, information can be fed directly into general ledger system
4. DBMS used to perform wide variety of functions

B. Coding

1. Typical coding needs
2. Computer generation of codes has increased efficiency and accuracy
3. Coding is initiated with receipt of application

C. Date recorded

1. Effective date of policy
2. Premium deficiency reserve – SSAP 5
3. Earned but unbilled premiums – SSAP 53

II. Billing

A. Primary insurance premiums

1. Direct or agency billed
 - a. Statement billing when company sends agent a statement listing policies written, and premium and coverage adjustments
 - b. Account current billing when agent renders a statement to insurer for premiums owed less agent's commission
 - c. Item billing when each transaction accounted for separately, with payment on individual basis
2. Premium financing
 - a. Arranged by insurer or through third party
 - b. By policy endorsement, charged to "premiums receivable deferred and not yet due"
 - c. By promissory note, charged to "bills receivable take for premiums"

3. Commissions
 - a. On direct billed, insurer generally pays following collection
 - b. On agency billed, agent withholds

- B. Reinsurance premiums

- C. Other premiums
 1. Underwriting syndicates, pools, and associations – same as other
 2. Retrospectively rated contracts

- D. Accounting Entries
 1. Direct billed creates a commission liability
 - Dr. Direct premiums receivable
 - Cr. Direct net premium written
 - Dr. Commission expense
 - Cr. Direct commission payable

 2. Agency billed
 - Dr. Agent billed premiums receivable
 - Dr. Commission expense
 - Cr. Direct premiums written

 3. Premiums subject to financing
 - Dr. Premiums billed but deferred
 - Cr. Agent billed premiums receivable
 - Cr. Commission payable

 4. Reinsurance
 - a. Assumed reinsurance
 - Dr. Premiums receivable
 - Dr. Commission expense
 - Cr. Assumed reinsurance premiums written
 - b. Ceded reinsurance
 - Dr. Ceded reinsurance premiums written
 - Cr. Ceded commission income
 - Cr. Ceded reinsurance payable

- E. Controls
 1. Failure can cause loss of revenue or defalcations, and inaccurate and misleading reports
 2. Documentation best through flowcharting process
 3. Basic control practices
 - a. Review of policies for proper underwriting
 - b. Verifying pricing and premium calculations
 - c. Early establishment of control totals
 - d. Segregation of billing, cashiering, and adjustment

- e. Stringent password access controls
- f. Stringent edit checks for code validity
- g. Assure that direct and reinsurance ceded recorded simultaneously
- h. Reconciliation of general ledger controls with statistical controls
- i. Verifying commission calculations
- j. Assure that continuous or multi-year policies properly billed
- k. Controls over auditable and retrospective rated policies for required action

III. Collecting

- A. Receipts
 - 1. Cash entries
 - 2. Quick cash availability for investment or operations
 - a. Lock boxes
 - b. Concentration accounts
 - c. Preauthorized electronic transfers
 - 3. Cash controls
 - a. Segregation of duties
 - b. Restrictive endorsement
 - c. Deposits intact daily
 - d. Deposit slips compared to cash receipt records
 - e. Depository accounts used for no other purpose
 - f. Independent reconciliation of bank statements
- B. Past due receipts and cancellation

IV. Reporting

- A. Management reports vary in form and content
 - 1. Premium production
 - 2. Premium collection
 - 3. Financial statements
- B. Statutory

V. Financing

- A. Subject to federal and state regulation
- B. Premium loan
 - 1. Collateral is unearned premium
 - 2. Finance charge calculations
- C. Deferred payment
 - 1. Personal lines
 - a. Flat fee service charge
 - b. Monthly payments with two months down

2. Commercial lines
 - a. Stipulated billing with down payment
 - b. Unearned premium serves as collateral

Chapter: Seven

Topic: Losses and Loss Expenses

Objectives: To understand the process of determining and recording losses and loss expenses.

I. Characteristics and Categories

A. Definitions

1. Loss incurred is an insured event which has happened
2. Loss paid is an insured event for which payment has been made
3. Loss reserve is estimated amount sufficient to pay loss at some time in future
4. Loss offset is a reduction of loss claim

B. Loss characteristics

1. Known versus unknown claims at close of accounting period
2. Reported (notice of loss received and recorded in statistical record) versus unreported
3. Property claims fully developed in 18 to 24 months (short-tail)
4. Liability claims fully developed in 3 to 5 years (long-tail)

C. Losses incurred

1. Subtract beginning loss reserves from loss payments, plus loss reserves at end of period

D. Losses paid

1. Total checks or drafts issued in settlement of claims
2. Traditional settlements
3. Structured claims settlements –payments scheduled into the future
 - a. SSAP 65

E. Losses reserved for future payment

1. Case loss reserves - those established by claim number
2. IBNR
3. Supplemental/Bulk reserves – not established by claim number
4. Reopened claim reserves
5. Claims In Transit (CIT) reserves
6. Claims-made reserves – losses recognized only as reported

- F. Loss offsets
 - 1. Salvage
 - a. Sale of damaged goods for which insured was indemnified
 - b. Losses directly reduced by amount of salvage
 - 2. Subrogation
 - a. Insured assigns to insurer any rights from third parties
 - b. Used to collect from negligent third party
 - 3. Claim refunds are return of previously paid claims
 - 4. No indemnity, or claims closed without payments
 - 5. Reinsurance

II. Loss Adjustment Expenses (LAE)

- A. Loss adjustment expenses – Expected payments for adjusting and recording losses
 - 1. Defense and cost containment (DCC) – includes defense, litigation, medical, surveillance, appraisers, private investigators, attorney’s fees for defense.
 - 2. Adjusting and other (AO) – includes adjusters, settling agents, attorney’s fees
For determination of coverage
- B. IEE – insurance expense exhibit – categories of expenses
 - 1. Loss adjustment expenses
 - 2. Acquisition, field supervision, and collection expenses
 - 3. General expenses
 - 4. Taxes, licenses and fees
 - 5. Investment expenses

III. Claim adjusters

- A. Independent adjusters – not employees of the insurer
- B. Company adjusters – salaried employees of the insurer
- C. Agents – only handle simple claimers

IV. Claim adjusting and processing

- A. Loss notification
- B. Claim file
 - 1. Claim jacket contains essential information pertaining to claim
 - 2. Claim coding
- C. Coverage triggers
 - 1. Occurrence-based – trigger is occurrence of event
 - a. Deemer clause places occurrence in one policy period even if

3. Accident year or policy year reports
4. Large loss reports
5. Adjusters work load

Chapter: Eight

Topic: Other Expenses

Objectives: To understand the classification of expenses and their allocation.

I. Introduction

- A. Each expense must be classified, allocated, and aggregated according to operating functions (NAIC Annual Statement Instructions and SSAP 70).
- B. *Financial Condition Examiners Handbook* specified that operating expenses shall be allocated to five major expense groups.
- C. Unique characteristic is time lag between sale and cost of coverage.
- D. Broader information required by management than SAP

II. Expense accounting

- A. Classification of expenses
 - 1. NAIC operating expense classifications (SSAP 70).
 - 2. Management expense classifications more detailed
 - a. Business planning
 - b. Evaluating plans and results
 - c. Determining prices
 - d. Justifying prices.
- B. Expense allocation to cost centers and then income producing segments
 - 1. NAIC reporting (SSAP 70) – 3 categories of allocable expenses on the Underwriting and Investment Exhibit – To achieve uniformity among insurers
 - a. LAE
 - b. Other Underwriting
 - c. Investment expenses
 - 2. Management reporting
 - a. Direct and indirect expenses and cost pools
 - b. Corporate expenses
- C. Internal accounting controls (Foreign Corrupt Practices Act of 1977 and Sarbanes-Oxley Act of 2002)
 - 1. Necessary to know degree of reliance on information
 - 2. Extent of audit procedures
 - 3. Expense information system
 - a. Record and account for disbursed and incurred expenses
 - b. Allocate expenses to income producing categories
 - c. Maintain balance between cost and benefit of information
 - 4. Standards for authorization and payment

D. Management accountability

1. Responsibility accounting
 - a. Follows organizational framework for hierarchy of cost centers
 - b. Stimulation and measurement of managers performance
2. Benchmarking – search for best practices
3. Budgeting is quantitative expression of cost of resources needed to attain objectives of plan
 - a. Variances between plan and results
 - b. Controllable vs. non-controllable expenses
4. Flexible budgets separate between fixed and variable costs and emphasize rates of change of costs.

III. **Expense reporting**

- A. NAIC
 1. The Annual Statement
 2. The Insurance Expense Exhibit
- B. Rate making
- C. Management and external reporting

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Chapter: Nine

Topic: Investment Income

Objectives: To identify the types of securities purchased for investments and the accounting or the investments and income.

I. Introduction

- A. Investment of policyholder funds unique feature
- B. Insurers receive cash to invest until claims are paid later
- C. Growth in liability with claims over longer periods
- D. Investment income increased significance
- E. More attention to maximizing total investment performance

II. Short-term instruments

- A. Types
 - 1. Commercial paper – unsecured promissory notes of corporations
 - 2. Certificate of deposit
 - 3. Treasury bills
 - 4. Repurchase, Reverse repurchase, and dollar repurchase agreements – purchase and subsequent repurchase by seller at agreed future date and price
 - 5. Money market funds

III. Long-term bonds

- A. U.S. Government Securities
- B. U.S. Government Agency and Government Sponsored Agency Securities
 - 1. Structured Securities
- C. Corporate Bonds
- D. Municipal Bonds
- E. Bond Mutual Funds
- F. Foreign and Eurodollar Bonds
- G. Surplus Notes
- H. Asset and investment income accounting
 - 1. Effective yield higher than market if sold at discount
 - 2. Effective yield lower than market if sold at premium
 - 3. Discount or premium amortized to produce effective yield when added (subtracted) to nominal yield
 - 4. Write cost periodically up or down
 - 5. NAIC recognizes only effective yield methods (SSAP 26)

6. Sales and exchanges recognizes gain or loss
7. Valuation
 - a. Generally at amortized cost
 - b. Bonds NAIC class 3, 4, 5, or 6 are lower of amortized cost or market

IV. Equities

- A. Common stocks (SSAP 30)
- B. Preferred stocks (SSAP 32)
- C. Warrants
- D. Mutual funds
- E. Asset and investment accounting
 1. Recorded at cost including commissions and taxes
 2. Recorded on trade date
 3. Sales and exchanges
 - a. Split-prorate cost to new shares held
 - b. Stock dividend same as split
 - c. Gain or loss on sale
- F. Valuation
 1. Common stocks – not a subsidiary is at SVO value, as prescribed by NAIC (usually market value)
 2. Common stocks – of a subsidiary carried at statutory equity method or market value method.
 3. Preferred stocks – cost, amortized cost, lower of cost or amortized cost, or Market depending on SVO rating.

V. Mortgages

- A. Reported on Schedule B
- B. SSAP 37
- C. Impaired loans have a valuation allowance, when impairment is other than temporary have a realized loss
- D. Sales – recognize a capital gain or loss
- E. Foreclosure – transferred to real estate
- F. Valued at unpaid principal less amortized discount

VI. Real Estate

- A. Can be reported on Schedule D or BA. Is on Schedule A if directly owned.
- B. SSAP 40
- C. Properties occupied – Reported at depreciated cost minus encumbrances.

VII. Derivatives- an agreement to buy, sell, settle for cash or exchange securities based on the performance, market price, interest rate, currency price of an underlying interest.

- A. Options
- B. Caps
- C. Floors
- D. Collars

- E. Swaps
- F. Forwards
- G. Futures – derivative traded on an exchange
- H. Asset and capital gain accounting
 - 1. Proceeds of call carried in deferred option account and reported as liability
 - 2. If option exercised, becomes part of consideration
 - 3. If option expires, treated as realized capital gain.

VIII. Other various investments

- A. Types (SSAP 4, 16, 19, 21, 22, 48,82)
 - 1. Partnerships – valued at with partner’s equity
 - 2. Leases – value depends on terms of lease
 - 3. Mineral rights – value based on proven mineral reserves
 - 4. Equipment – can be valued like real estate or leases

IX. NAIC Model Investment Law

X. Securities Lending

- A. Securities lent to brokerage for compensation
- B. Valuation is unaffected if required collateral is held (specified in Valuation of Securities Manual)

XI. Investment Performance

XII Control Procedures

Chapter: Ten

Topic: Other Income and Direct charges and Credits to Surplus

Objectives: To identify items of other income and direct charges and credits to surplus.

I. Other income

- A. Net gain or loss from agents or premium balances charged off
- B. Finance and service charges not included in premiums
- C. Aggregate write-ins for miscellaneous income
 - 1. Premiums for life insurance on employees if company is beneficiary
 - 2. Checks canceled because of nonpresentation for payment (subject to state Escheat laws)
 - 3. Gain or loss on sale of equipment
 - 4. Retroactive reinsurance (loss portfolio transfer)
 - 5. Gain or loss on foreign exchange
 - a. SSAP 23
 - b. This write-in arises from the sale or conversion of foreign currencies by international insurers
 - 6. Corporate expense
 - 7. Fines and penalties of regulatory authorities
 - a. Shown as a separate item on the annual statement regardless of materiality
 - 8. Miscellaneous income or expense
- D. Dividends to policyholders are return of premiums
- E. Federal and foreign income taxes incurred (SSAP 10)

II. Gains and losses in surplus (SSAP 72)

- A. Net unrealized capital gains or losses results from change in statement value of investments between reporting dates
- B. Change in net unrealized foreign exchange capital gains (losses) (SSAP 23)
- C. Change in net deferred income tax (SSAP 10)
- D. Change in nonadmitted assets (SSAP 4)
- E. Change in provision for reinsurance (Schedule F penalty)
 - 1. Occurs when credit is not allowed because business has been ceded
 - a. To unauthorized companies (state laws vary as to authorization) or
 - b. Recoverable balance is overdue – paid loss and paid LAE more than 90 days past due.
- F. Change in surplus notes (SSAP 41) – any subordinated indebtedness used for Financing increasing surplus
- G. Surplus contributed to (withdrawn from) protected cells (SSAP 74) an insurance

linked security can be issued through a protected cell (similar to a separate account)

- F. Cumulative effect of changes in accounting principles (SSAP 3)
 - 1. Anticipated salvage and subrogation
 - 2. Postretirement benefits other than pensions (SSAP 14)
 - 3. Tabular discounts (SSAP 65)
- G. Capital changes
 - a. Transfer from surplus to capital for a stock dividend
 - b. Transfer from capital to surplus for a reduction in par value without a reduction in shares outstanding
- H. Surplus adjustments
 - a. The difference between par or stated value and the price of shares Issued or retired.
- I. Net remittances from or to home office
 - a. The net cash flow between a US branch of a foreign company and the home office in a foreign country.
- J. Dividends to stockholders
 - a. Only from retained earnings
 - b. Must be declared by board of directors
 - c. NAIC Model Holding Company Act – must submit extraordinary dividends to the Commissioner
- K. Change in treasury stock (SSAP 72)
- L. Aggregate write-ins for gains and losses in surplus

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Chapter: Eleven

Topic: Reinsurance Accounting

Objectives: To describe the reinsurance process and accounting for reinsurance.

I. The reinsurance business

A. Definition and purposes

1. Transaction whereby reinsurer, for consideration, agrees to indemnify another insurance company, ceding company
2. Multiple, functions of reinsurance
 - a. To increase underwriting capacity – to accept larger exposures
 - b. To protect capital/stabilization – controls the impact of underwriting losses
 - c. To stabilize underwriting results
 - d. To spread and/or reduce risk – especially geographic concentrations
 - e. To achieve size homogeneity – “Law of Large Numbers”
 - f. Withdraw from or enter a geographic area or line of business
 - g. To finance growth

B. Reinsurance forms and placement methods

1. Pro rata - Proportional sharing of losses
 - a. Quota share – reinsurer assumes agreed percentage of each risk
 - b. Surplus share – share percentage varies by type of risk
 - c. Portfolio – 100% cession of a block of business
2. Excess of loss - Nonproportional
 - a. Per risk excess of loss
 - b. Per occurrence excess of loss
 - c. Per aggregate excess of loss (stop loss)
3. Placement
 - a. Facultative – a separate negotiation for each cession
 - b. Treaty – a standing agreement to cede risks as defined in the treaty
4. Other risk transfer products
 - a. ILW – Industry Loss Warranty contract
 - b. Castastrophe bonds
 - c. SPV – Special purpose vehicles
 - d. Protected cells

II. Statutory versus GAAP Accounting

- A. GAAP: emphasis is on going concern (SFAS 113)
- B. Statutory: emphasis is on solvency (SSAP 62)
- C. Differences
 - 1. Balance sheet
 - a. SFAS recoverables are gross
 - b. SSAP recoverables are net
 - 2. Income statement
 - a. Both recognize revenues and expenses net
 - 3. Retroactive reinsurance
 - a. SFAS gain is deferred and amortized
 - b. SSAP gain is recognized
 - 4. Unauthorized reinsurance
 - a. SFAS – no reduction
 - b. SSAP – ‘Schedule F penalty’
 - 5. Retrospectively rated reinsurance
 - a. SFAS – computed on least costly alternative to ceding company
 - b. SSAP – computed based on experience to date
 - 6. Structured settlements
 - a. SFAS and SSAP are consistent
 - 7. Transfer of risk
 - a. SFAS – must be a reasonable possibility of loss to reinsurer
- D. Deposit accounting rules
- E. Commutation accounting

III. Accounting Differences Between Primary Insurance and Reinsurance

- A. Time lag – 4 to 6 weeks
- B. By-line breakdown
- C. Balances due from reinsurer includable without time limitation
- D. Loss expense reserve similar to insurance
- E. Loss reserving practices not as affected by law of large numbers

IV. Recording

- A. Underwriting income
 - 1. Premiums earned
 - a. Written
 - b. Reserve for unearned premium required
 - 2. Losses incurred – largest single outlay
 - 3. Loss expenses incurred
 - 4. Ceding commissions – to reimburse ceding company for acquisition expenses – second largest outlay
 - 5. General expenses
- B. Investment Income

C. Other income

V. Reporting

A. External

1. Annual statement requirements
2. Reporting to governments
 - a. State – submits annual statement
 - b. Federal
 1. IRS
 2. US Treasury – certificate of authority to write surety bonds on US Obligations
 3. Department of Commerce – reporting transactions between US and Foreign companies
 4. SEC – only publicly traded stock companies
3. Foreign governments
4. To non-government organizations
 - a. Security analysts
 - b. Financial rating organizations

B. Internal reporting

1. More concerned with business process and growth
2. Less detail and more summation
3. Less structure

Chapter: Twelve

Topic: Taxation

Objectives: To outline the corporate tax laws as they apply to property and liability insurance companies.

I. Defining insurance for tax purposes

- A. A company that derives more than half of its business from issuing insurance or annuity contracts or reinsuring the risks of other insurance companies.
- B. An activity constitutes insurance if it shifts a risk of loss and distributes a risk of loss among insureds

II. Efficacy of the Annual Statement – basis for computing tax

- A. Most frequent challenge is estimated unpaid losses and loss adjustment expenses
- B. Treasury reserves right to challenge estimate
- C. Burden of support is on taxpayer
- D. IRS continues to challenge Annual Statement accounting with increasing success

III. Tax rules unique to property and liability insurers

- A. Underwriting income
 - 1. Premiums earned
 - a. Include 20% of increase in unearned premium reserve
 - b. Amortize
 - 2. Losses incurred
 - a. May deduct reasonable estimates of unpaid losses and loss expenses after the loss event has occurred
 - b. Discounting loss reserves and loss adjustment expenses
 - 1. Discounting spreads deduction over a number of years to reflect assumed investment earnings
 - 2. Discount determined by three factors: gross amount, pattern of claims payments, and interest rate
 - 3. Required to reduce loss reserve by discounted salvage
 - 3. Expenses incurred
 - a. All expenses shown on Annual Statement
 - b. 1984 Act introduced limitations governing timing, in year of economic event occurred
- B. Investment income
 - 1. Accrual of discount and amortization of premium
 - 2. Market discount not accruable, taxed as ordinary income when sold, except tax-exempts then capital gain

3. Dividends constitute gross income on cash basis subject to dividend received deduction
 4. Proration-exempt investment income
 5. Capital gains and losses
 6. "Mark to market" must state securities at market value
 7. Ordinary loss deduction when capital asset sold to meet "abnormal insurance losses"
 8. United States branches of alien insurers
- C. Alternative minimum tax: preferences affecting insurers
1. AMT imposed on 20% of AMTI in excess of \$40,000 if AMT is greater than regular tax
 2. AMTI computed with adjustments to regular taxable income
 3. AMT adjustments
 - a. Tax preference items
 - b. Adjustments

IV. Tax rules applicable to Mutuals and Reciprocals, and Other Special Entities

- A. After 1986 mutual taxed identically to stock company
- B. Reciprocals taxed as other insurer except
 1. Waive deduction for amounts to attorney-in-fact
 2. Deduct increase in savings credited to subscriber accounts
 3. If acquisition expenses were deducted from UEP, must add back
- C. Pools
- D. Exchange syndicates

V. Tax-exempt and Small non-life insurance companies

- A. Exempt from federal income tax if net written premiums or direct written premiums do not exceed \$350,000
- B. With annual premiums of \$350,000 to \$1,200,000 may elect to be taxed only on investment income

VI. General corporate tax rules fundamental to insurers

- A. All corporate tax rules apply unless specifically superseded
- B. Based primarily on Annual Statement
- C. Depreciation
 1. Furniture, fixtures, automobiles are capitalizable
 2. Depreciated using ACRS, MACRS, or straight-line using applicable lives specified by IRS
- D. Amortization of intangible assets
- E. Capitalization issues
- F. Carrybacks and carryforwards
- G. Issues affecting employers and employees
 1. Can establish qualified retirement and welfare plans
 2. Care in defining independent contractors

VII. Consolidated federal income tax returns

- A. Affiliated group may file consolidated return
- B. Offsets net loss in one company against net income of another
- C. Inter-company dividends eliminated

VIII. Captive insurance companies and risk funding

- A. Captive insurance companies are companies that whole or in part insure related party risks
- B. Insurance purchased from an affiliate did not qualify as insurance until June, 2001

IX. Foreign corporations

- A. Controlled foreign corporations
- B. Domestic company election
- C. Branch tax

X. Other tax aspects

- A. Excise taxes
 - 1. Foreign insurers and reinsurers – 4% excise tax
 - 2. Loss transfers and payments to captives
 - 3. Surplus lines
 - 4. Treaty countries

XI. Income Tax Accounting

- A. GAAP
 - 1. Balance sheet approach
 - 2. Deferred tax assets – SFAS 109
- B. NAIC Accounting – Codification (SSAP 10)
 - 1. Admissibility standard
 - 2. Recording deferred tax provision
 - 3. State income tax provision
 - 4. Disclosure requirements
 - 5. Tax contingencies

XII. Dealing with the IRS

- A. Examinations, technical advice and appeals procedures
- B. Appeals to tax court and other courts
 - 1. Decisions of Tax Court appealed to Court of Appeals
 - 2. Decision of Court of Appeals appealed to US Supreme Court

XII. State and local taxation

- A. State taxes
 - 1. General taxes
 - a. Income tax
 - b. Franchise tax

2. Premium-based taxes
 - a. Imposed on gross premiums received
 - b. Credits for other taxes paid
3. Miscellaneous taxes
 - a. Fire prevention taxes
 - b. Underwriting profits tax on marine coverages
 - c. Licensing and filing fees
 - d. Assessments
 - e. Guaranty funds

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Chapter: Thirteen

Topic: Accounting for Income Taxes

Objectives: To understand accounting for income taxes under GAAP (SFAS 109) and Under SAP (SSAP 10)

I. Statement of Financial Accounting Standards No. 109

- A. Objective
 - 1. Recognize amount of taxes payable or refundable for current year.
 - 2. Recognize deferred tax assets and liabilities for future tax consequences
- B. Scope
- C. Basic Principles
 - 1. A current tax liability (asset) is recognized based on the taxes payable (refundable) on current year's tax return
 - 2. Deferred tax assets and liabilities are recognized for future tax effects of temporary differences and carry-forwards
 - 3. Measurement of current and deferred tax liabilities and assets is based on current laws, not anticipated changes
 - 4. Measurement of deferred tax assets is reduced by any tax benefits not expected to be realized
- D. Balance Sheet Approach
- E. Temporary Differences
- F. Intraproduct Tax Allocation
- G. Disclosure

II. Statement of Statutory Accounting Principles 10

- A. Objective/Scope
- B. SSAP 10 vs. SFAS 109
- C. Balance Sheet Approach
- D. Temporary Differences
- E. Admissible Deferred Tax Assets

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Chapter: Fourteen

Topic: Generally Accepted Accounting Principles

Objectives: To describe differences between generally accepted accounting principles and statutory accounting principles.

I. Sources of accounting principles

- A. Since 1973, Financial Accounting Standards Board (FASB)
 - 1. Statements of Financial Accounting Standards
 - 2. Statements of Financial Accounting Concepts
 - 3. Interpretations of Financial Accounting Standards
 - 4. Technical Bulletins
 - 5. Emerging Issues Task Force
- B. Securities and Exchange Commission
 - 1. Designated FASB as authority
 - 2. Financial Reporting Releases
 - 3. Staff Accounting Bulletins
- C. Historically SAP discharges statutory responsibilities
- D. SAP places emphasis on balance sheet and financial condition

II. Differences between SAP and GAAP

- A. Difference lies in respective users and objectives
 - 1. SAP designed to assist state regulatory authorities
 - 2. SAP reports ability to meet obligations to policyholders and claimants
 - 3. SAP focuses on surplus adequacy
 - 4. GAAP designed to report information about economic resources, claims to those, and transactions that change resources and claims
 - 5. GAAP focus is on earnings and its components
- B. Assets
 - 1. Nonadmitted assets (SSAP 4 and 20)
 - a. Do not conform to laws and regulations
 - b. Not readily convertible to liquid assets
 - 2. Most entered on ledger and excluded from statutory balance sheet by direct charge to surplus
- C. Investments
 - 1. SAP
 - a. Bonds in good standing carried at amortized cost
 - b. Bonds not in good standing carried at NAIC values

- c. Common and preferred stock carried at values published by NAIC
 - d. Investment in subsidiaries carried at statutory net worth of subsidiary
2. GAAP
- a. Bonds classified as held to maturity carried at amortized cost if company has both ability and intent to hold to maturity
 - b. If bonds are classified as trading, reported at market-values and unrealized gains and losses, net of tax, reported in income statement.
 - c. If bonds are classified as available for sale, reported at market values and unrealized gains and losses, net of tax, reported in stockholders equity
 - d. Common and nonredeemable preferred stocks reported at market with gains and losses, net of tax reported in stockholders equity
 - e. Parent with controlling interest consolidates
- D. Derivatives
- 1. SSAP 31 – account for in a manner consistent with the hedged asset or liability
 - 2. SFAS 133 – largest step toward a fair value balance sheet
- E. Policy acquisition costs
- 1. Significant element of expense
 - 2. Under SAP, charged to current operations
 - 3. Under GAAP, capitalized and charged to expense in proportion to premium revenue recognized
- F. Policyholder dividends
- 1. SAP does not accrue
 - 2. GAAP Accrues
- G. Contingent commissions
- 1. SAP (SSAP 65) – uses full accrual basis
 - 2. GAAP requires accrual
- H. Loss and loss expense reserves
- 1. Both SAP and GAAP require
- I. Salvage and subrogation
- 1. Under SAP can recognize on receipt or accrue to reduce related reserve
 - 2. Under GAAP, valued at estimated realizable value and applied as reduction of reserve
- J. Federal income tax expense

Chapter: Fifteen

Topic: SEC Reporting Requirements

Objectives: To describe reporting under other federal and stock exchange regulations

I. Federal regulations and statutes

- A. Securities Act of 1933
 - 1. Provides for registration of securities offered or sold to public
 - 2. Disclosure by means of registration statement and prospectus
 - 3. Various forms
- B. Securities Exchange Act of 1934
 - 1. Created the Securities and Exchange Commission
 - 2. Requires registration for securities listed on national exchanges and periodic reporting to stockholders
 - 3. Forms: 10-K., 10-Q, 8-k
- C. Regulation S-K sets forth content of nonfinancial portions of Securities Act registration statements

II. EDGAR

- A. Electronic Data Gathering, Analysis, and Retrieval system

III. Stock Exchanges

- A. New York Stock Exchange (NYSE)
- B. American Stock Exchange (AMEX)
- C. NASDAQ

Chapter: Sixteen/Seventeen

Topic: Financial Strength/Financial Management

Objectives: To describe the characteristics and measurement of financial strength for a property-liability insurer.

I. Analysis of financial strength increasingly significant

II. Financial strength

- A. The power and capacity to meet more than minimum obligations
- B. One of the most important ingredients is management talent and stewardship
- C. Recognizes special fiduciary role of the insurer

III. Sources of information and financial evaluation

- A. State insurance departments
- B. New media
- C. Marketing intelligence
- D. Rating services

VI. Evaluating financial strength

- A. IRIS tests
 - 1. Series of financial ratios highlight insurers targeted for more thorough attention
 - 2. Designed to support regulatory function
 - 3. Twelve tests in four groups
 - a. Gross premium to surplus
 - b. Net premiums to surplus
 - c. Change in net writings
 - d. Surplus aid to policyholders' surplus
 - e. Two-year overall operating ratio
 - f. Investment yield
 - g. Change in policyholders' surplus
 - h. liabilities to liquid assets
 - i. Agents' balances to policyholders' surplus
 - j. One-year reserve development to policyholders' surplus
 - k. Two-year reserve development to surplus

1. Estimated current reserve deficiency to surplus
4. Results compared to critical value for each test

IV.

Financial Management

- A. Fiduciary responsibility
- B. Sarbanes-Oxley Act
- C. Financial Planning
 1. Strategic plans
 2. Capital budgets
 3. Operating budgets
- D. Financial Controls
- E. Investment and Treasury Function

Chapter: Eighteen

Topic: Canadian Accounting

Objectives: To describe the differences between US and Canadian property and liability insurance accounting

I. Evolution of the industry

- A. Strongly influenced by UK and US
- B. Registered at either federal or provincial level
- C. Most under jurisdiction of Office of Superintendent of Financial Institutions primarily concerned with stability and solvency
- D. Three classes
 - 1. Domestic provincially registered
 - 2. Domestic federally registered
 - 3. Branch of a foreign insurer
- E. Current regulatory developments – Insurance Companies Act 1992
- F. Accounting standards
 - 1. Established by CICA
 - 2. 1974 research study – “Financial Reporting for Property and Casualty Insurers” concluded GAAP provides more useful information to owners and other users, and statements filed with OSFI should be on GAAP
 - 3. 1977 law permitted using GAAP for Annual Statement

II. The Canadian Annual Return

- A. First 15 pages form complete package of GAAP audited financial statements
- B. Most items similar to NAIC Blank
- C. Canadian classifications

III. Taxation

- A. Types of taxes
 - 1. Taxes based on income
 - 2. Insurers may deduct
 - a. Reasonable reserve for doubtful debts
 - b. Reserve for unearned premiums
 - c. Reasonable claims reserve
 - 3. Canadian branches

4. Tax on an insurer's investments
 5. Tax on insurer's capital
 6. Other taxes by provinces
 7. Goods and services tax
 - a. Tax paid at each state of process of providing goods and services
 - b. Most types of insurance exempt
 - c. Exempt businesses experience increase of cost of conducting business by taxex they are unable to pass on
- B. Accounting for income taxes uses balance sheet approach with asset-liability method.