

# Statutory Issue Paper No. 12

## Accounting for Drafts Issued and Outstanding

### STATUS

Finalized March 16, 1998

Original SSAP; SSAP No. 2; Current Authoritative Guidance: SSAP No. 2R

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. Current statutory accounting, as documented in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, provides guidance on the accounting for drafts but does not provide a definition of a draft. This issue paper will establish a definition for “draft” and will codify statutory accounting relating to drafts.

### SUMMARY CONCLUSION

2. For purposes of statutory accounting, a “draft” is defined as an order to pay a sum certain in money, which is signed by the drawer (e.g., the insurance company or its agent), and payable to order or bearer (policyholder) by the drawee (bank) only upon approval by the insurance company once the draft has been presented to the drawee.

3. A reporting entity that utilizes instruments that meet the above definition of drafts shall elect one of the following accounting methods:

a. **Draft Issued Method** - When a draft is issued, an increase in paid losses and a related decrease in loss reserves is recorded. Drafts that have not been presented for payment and remain outstanding at the balance sheet date are reflected as a liability.

b. **Draft Honored Method** - An increase in paid losses and a related decrease in loss reserves is recorded when the draft is cashed and presented by the bank to the reporting entity for reimbursement. Consequently, under a draft honored method there is no liability for outstanding drafts.

The method elected by a reporting entity to account for drafts issued and outstanding shall remain consistent from year to year. Procedures for changes in the accounting method shall be governed by *Issue Paper No. 3—Accounting Changes*.

### DISCUSSION

4. Statutory accounting does not address the characteristics of a draft, however, Chapter 13, *Other Liabilities*, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies does provide specific guidance on how to account for drafts. This guidance is consistent with GAAP accounting procedures for outstanding drafts as discussed in *AICPA Statement of Position 92-4, Auditing Insurance Entities’ Loss Reserves*.

5. Drafts and checks have different legal characteristics. A check is payable on demand, whereas a draft must be approved for payment by the issuer (the reporting entity) before it is honored by the bank. Because of these different characteristics, a draft meets the definition of a liability as defined by NAIC

*Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.* Outstanding checks are accounted for as a reduction of cash.

### **Drafting Notes/Comments**

None

## **RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

### **Statutory Accounting**

6. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13, *Other Liabilities*, discusses the accounting for drafts as follows:

Companies may record loss and loss expense drafts written to claimants and policyholders on either a draft issued or a draft honored basis. On an issued system, paid losses and appropriate loss reserve releases are recorded when the draft is issued. Drafts that have not been presented for payment and remain outstanding at the balance sheet date are reflected as a liability under this caption.

Companies on a draft honored system do not record paid losses or release loss reserves until the drafts are cashed and presented by the bank to the company for reimbursement. Consequently, under a draft honored system there is no liability for outstanding drafts.

### **Generally Accepted Accounting Principles**

7. *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves* as incorporated through Appendix L of the AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies, discusses the accounting for drafts as follows:

Drafts outstanding - Some insurance companies may elect to pay claims by draft rather than by check and may not record the drafts as cash disbursed until the drafts are presented to the insurer by the bank. A liability for drafts outstanding is required only if cash disbursements and claim statistical information are not recorded concurrently, thereby creating a timing difference. Because the claim statistical information is updated to reflect the payment, no loss reserve is recorded for the claim; however, because the draft has not been presented, a drafts outstanding liability is required.

## **RELEVANT LITERATURE**

### **Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13

### **Generally Accepted Accounting Principles**

- *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves*
- *AICPA Audit and Accounting Guide: Audits of Property and Casualty Insurance Companies*

### **State Regulations**

- No additional guidance obtained from state statutes and regulations.