

Statutory Issue Paper No. 53

Property Casualty Contracts - Premiums

STATUS

Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 53

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for premium recognition for property and casualty contracts, as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance Contracts In Force* (Issue Paper No. 50), is contained in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices Procedures Manual). Under current statutory accounting, different methods are used for recording premiums. Regardless of the method used, premiums are generally recognized as earned in the statement of operations over the period of risk in proportion to the amount of insurance protection provided. Premiums for title insurance, mortgage guaranty insurance, financial guaranty insurance, retrospectively rated or other experience-rated contracts and single or fixed premium policies with coverage periods in excess of thirteen months are not included in the scope of this issue paper, but will be addressed in separate issue papers.

2. GAAP provides only general guidance on how to record premium, however GAAP requires an unearned premium reserve to be established and premium revenue to be recognized over the period of risk in proportion to the amount of insurance protection provided.

3. The purpose of this issue paper is to establish statutory accounting principles for the recording and recognition of premium revenue for property and casualty contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to property and casualty contracts as defined in Issue Paper No. 50. It will establish the basic underlying accounting principles for premium revenue recognition of property and casualty insurance contracts and will be used as the basis to ensure consistency when establishing statutory accounting principles for revenue recognition.

5. Except as provided for in paragraph 6, written premiums shall be defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits and expenses associated with the coverage provided by the terms of the insurance contract. Frequently, insurance contracts are subject to audit by the insurer and the amount of premium charged is subject to adjustment based on the actual exposure. These premium adjustments are discussed in paragraph 10 of this paper.

6. For workers' compensation contracts, which have a premium based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract and written premium is recorded on the basis of that frequency.

7. Written premiums for all other contracts shall be recorded on the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Unearned premium reserve meets the definition of a liability as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5).

8. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of property and casualty contracts shall be recognized in the statement of operations, as earned premium, using either the daily pro-rata or monthly pro-rata methods as described in paragraph 17. Certain issue papers provide for different methods of recognizing premium in the statement of operations for specific types of contracts. For contracts not separately identified in specific issue papers where the reporting entity can demonstrate the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

9. Additional premiums that are charged to policyholders for endorsements and for changes in coverage under the contract shall be recorded on the effective date of the endorsement and accounted for in a manner consistent with the methods discussed in paragraphs 7 and 8 so that at any point in time a liability is accrued for unearned premium equal to the premium amount charged for the unexpired portion of the policy endorsement.

10. Adjustments to the amount of premium charged for changes in the level of exposure to insurance risk (such as audit premiums on workers' compensation policies) are generally determined based upon audits conducted after the policy has expired. Reporting entities shall estimate audit premiums, the amount generally referred to as earned but unbilled (EBUB) premium, and shall record such amounts as an adjustment to premium, either through written premium or as an adjustment to earned premium. Such amounts meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*. Such amounts shall be adjusted upon completion of the audit and the adjustment shall be recognized as revenue immediately. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using company historical unearned premium data, or per policy calculations. Upon completion of an audit that results in a return of premiums to the policyholder, earned premiums shall be reduced. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis, must be reported in the annual statement as a nonadmitted asset, however, to the extent that amounts in excess of the 10% are not anticipated to be collected they shall be written off against operations in the period the determination is made. Reporting entities shall establish all of the requisite liabilities associated with the asset such as commissions and premium taxes.

11. When the anticipated losses, loss adjustment expenses commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each such grouping where a premium deficiency is indicated. Such deficiencies shall not be offset by anticipated profits in other policy groupings. If an reporting entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the notes to the financial statements.

Disclosure Requirements

12. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

- a. Name and address of managing general agent or third party administrator;
- b. Federal Employer Identification Number;
- c. Whether such person holds an exclusive contract;
- d. Types of business written;
- e. Type of authority granted (i.e., underwriting, claims payment, etc.); and
- f. Total premium written.

DISCUSSION

13. This issue paper adopts current statutory guidance for all property and casualty contracts, except as outlined below. This issue paper modifies current statutory accounting to record the written premium based upon the effective date of the policy or endorsement, except for workers' compensation premiums as discussed in paragraph 6 and premiums which are subject to adjustment, whereas current statutory accounting allows the recording of the premium when the daily report is processed, when the premium is due, or when the premium is paid. This issue paper therefore rejects the conclusions of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force reached in 1990 and reaffirmed on March 8, 1993, as it relates to premiums other than workers' compensation, which allowed for certain written premiums to be recorded as billed. These changes were made to improve consistency in reporting. This is consistent with *Issue Paper No. 6—Amounts Due From Agents and Brokers* and *Issue Paper No. 10—Uncollected Premium Balances*. The pro-rata methods described in this issue paper provide for premium to be earned in proportion to the exposure to insurance risk for most property and casualty contracts as in most contracts the exposure to insurance risk does not vary significantly during the contract period. Property and casualty contracts where the exposure to insurance risk varies significantly during the contract period and it may not be appropriate to earn premium on a pro-rata basis are addressed in specific issue papers. For those few contracts not addressed in specific issue papers where the exposure to insurance risk varies significantly during the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. This paper also modifies current statutory accounting by requiring the recognition of a premium deficiency in circumstances described in paragraph 11. Current statutory guidance is silent regarding premium deficiency. This issue paper modifies current statutory guidance to allow EBUB to be recorded either through written premium or as an adjustment to earned premium. This change was made to provide consistency between the recording of this type of premium adjustment and retrospective premium adjustments.

14. The conclusions above reject *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60). The recognition of unearned premium as earned is consistent with GAAP except for those policies where the exposure to insurance risk differs materially during the contract period for which specific methods have been provided for the recognition of unearned premium as earned in certain issue papers. The recognition of a percentage of EBUB premium in excess of collateral as a nonadmitted asset is also not required by GAAP but is consistent with the conservatism and recognition concepts of statutory accounting.

15. The unearned premium reserve meets the definition of a liability as defined in Issue Paper No. 5. That issue paper defines liabilities as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or events. As stated in FAS 60 "*premiums from short-duration insurance contracts, such as property and liability insurance contracts, are intended to cover expected claims costs resulting from insured events that occur during a fixed period of short-duration.*" Therefore,

the unearned premium reserve represents the premium to be earned in the future intended to cover the unexpired portion of the policy which generally relates to the future sacrifice of economic benefit, which are the claim costs the reporting entity will pay if losses are incurred during the contract period.

16. Recording the premium as revenue in proportion to the period that insurance protection is provided is consistent with the Recognition concept in the Statement of Concepts. The Recognition concept states, “*revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed.*” Therefore, as the period that is protected expires, the underlying earnings process is completed and the revenue should be recognized.

Drafting Notes/Comments

- Accounting for specific types of property and casualty insurance contracts will be addressed in separate issue papers.
- Accounting for reinsurance will be addressed in *Issue Paper No. 74—Life and Accident and Health Reinsurance* and *Issue Paper No. 75—Property and Casualty Reinsurance*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

17. Chapter 14, Premiums, in the P&C Accounting Practices and Procedures Manual contains the following guidance pertaining to premiums:

Different methods of recording written premiums are used and generally follow the company's plan of operation. For example, premiums may be recorded when the daily report is processed, when the premium is due, or when the premium is paid. Many companies use combinations of these methods. Whatever recording method is used, premiums written include the following categories: direct premiums, assumed reinsurance premiums and ceded reinsurance premiums.

Direct Premiums

The major portion of most companies' premiums written is direct premiums. Direct premiums include all premiums arising from policies issued by the company acting as the primary insurance carrier. These premiums should be adjusted for any return or additional premiums arising from endorsements, cancellations, audits, and retrospective rating plans.

Direct written premiums are generally recorded for the full policy term. See Chapter 7—Agents' Balances or Uncollected Premiums, for recording of uncollected premiums.

Endorsement entries generally follow the same recording path as the original entries. Those policies subject to audit may be adjusted on a monthly, quarterly, semi-annual, or annual basis with the premium resulting from a physical review of the exposure immediately recorded as written. Adjustments resulting from retrospective rating plans are immediately recorded as written premiums.

Assumed and Ceded Reinsurance Premiums

Assumed reinsurance premiums include all premiums (less return premiums) from contracts issued to reinsure another insurance company. Ceded reinsurance premiums include all premiums (less return premiums) transferred to another insurance company for reinsurance purchased.

Net Written Premiums

The net written premiums of an insurance company are equal to the direct premiums, plus the reinsurance assumed premiums, less the reinsurance ceded premiums. Net written premiums are shown in the Underwriting and Investment Exhibit of the annual statement.

Earned Premiums

The earned premiums of an insurance company represent the pro rata portion of the premiums in force applicable to the expired portion of the policy term, plus or minus the premiums earned on audits and other adjustments. To compute earned premiums, deduct from net premium writings the net change which has taken place during the period in total unearned premium reserve.

The Underwriting and Investment Exhibit of the annual statement shows the components of earned premiums during the year for each line of business. The total earned premiums are reported in the Statement of Income of the annual statement.

Earned But Unbilled Premiums

Earned but unbilled premiums (EBUB) typically arise out of the issuance of workers' compensation policies. Since workers' compensation premiums are usually based on payroll statistics, premium billings to the employer are generally estimated and are subject to insurer audit, at which time the true final premium is calculated. If the actual payroll exceeds the payroll figure used in the calculation of premium billings, an additional premium may be owed the insurer. If the actual payroll is less than that used in the premium billing calculation, a return premium may be owed the employer.

An insurer may recognize as an asset accrued EBUB. Actuarially or statistically supported aggregate calculations, using company historical unearned premium data, or per policy calculations are acceptable methods of establishing this asset. To the extent an insurer chooses to recognize the asset for EBUB, it must establish all of the requisite liabilities associated with the asset such as commissions and premium taxes.

EBUB should be reported in the annual statement as written premium and premium receivable. It should not be netted against unearned premiums. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis must be reported in the annual statement as a non-admitted asset.

18. Chapter 12, Unearned Premiums, in the P&C Accounting Practices and Procedures Manual contains the following guidance pertaining to unearned premiums:

At the expiration of an insurance contract or policy, the entire premium has been earned. Any point prior to expiration, the company is required to establish a pro rata portion of the premium as a liability to cover the remaining policy term. The company's total unearned premium reserve represents the unearned premium liability for all policies in force.

A number of methods are used for the computation of the unearned premium reserve. In one method, the unearned premiums are calculated by applying the appropriate factors or fractions to the original premiums in force, segregated by line of business, term, and date of expiration. The premium for the full original term is used for this purpose because the factors or fractions are calculated on the basis. When a policy is canceled, the full original premium should be deducted from the total premium in force; otherwise, premiums in force and unearned premiums would be overstated. During the life of a policy, changes are frequently made, resulting in additional or return premiums. For example, a one-year policy may have its premium increased or decreased by a change in coverage after it has been in force for six months, in which case the insured might pay additional premium or receive a return premium. Theoretically, the full annual premium for changes should be calculated so that premiums in force for the one-year term may be correspondingly increased or decreased. However, as a practical matter, some companies adjust the premiums in force by the amount of the actual additional premium or return premium, other than in the event of cancellation, on the assumption that the resulting errors in the premiums in force will largely offset one another.

One of the more common assumptions used by companies to calculate an unearned premium reserve is the monthly pro rata method. This method assumes that, on the average, the same amount of business is written each day of any month so that the mean will be the middle of the month. For example, one-year premiums written during the first three months of the year have, at the end of the year, the following unearned fractions: January-1/24; February-3/24; March-5/24.

A second method is to calculate the unearned premium on each policy. At the end of each period, the calculation is made on each item of premium to ascertain the unexpired portion and to arrive at the aggregate unearned premium reserve.

If a company assumes reinsurance, it must provide the same unearned premium reserve that would have been provided by the ceding company if reinsurance had not been placed.

There are a number of methods used to calculate unearned premium reserve. Certain states have a provision in their statutes which prescribes the method or methods which should be used.

Audited Policies

Audited premiums are earned as soon as they are recorded, whether they are interim audits or final audits. Many audited policies are written with a deposit premium and provide for monthly, quarterly, or semi-annual audits in addition to the final audit after expiration. Deposit premiums should be earned in such a manner that in conjunction with interim and final audits, earned premium will be correctly reflected during the policy term.

19. Pertinent excerpts of the December 3, 1990 meeting minutes of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group) are as follows:

At its September 10, 1990 meeting (EI 90-3) the working group then adopted the following accounting manual language subject to the development of suitable disclosures and interrogatories:

Written premiums may be recorded at the processing point where the premium amount and term are determinable, e.g., when the daily report is processed, when the premium is billed, or when the premium is collected.

Contracts which have both a fixed policy period and a fixed premium are recorded at the inception date for the term of the policy. This approach should be used in cases where policies have a fixed premium but offer policyholders the option to pay monthly, quarterly, or on some other modal basis, and in cases where the premium has been financed with the insurer receiving the full premium.

For contracts which have a premium based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract and written premium is recorded on the basis of that frequency.

Generally Accepted Accounting Principles

20. FAS 60 contains the following guidance pertaining to revenue recognition for short-duration contracts:

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim¹ costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

¹ Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this statement.

9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a liability for claim adjustment expenses shall be accrued when insured events occur.

Premium Revenue Recognition

Short-Duration Contracts

13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

21. Paragraph 33 of FAS 60 provides the following guidance on accounting for premium deficiencies on short-duration contracts:

A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.⁶

⁶ Disclosure is required regarding whether the insurance enterprise considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists (paragraph 60.e.).

22. The *AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies* contains the following regarding revenue recognition under GAAP:

Revenue Recognition

3.32. Premiums from a short-duration contract ordinarily should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. This generally results in premiums being recognized as revenue evenly over the contract period. Under a few kinds of contracts, the period of risk differs significantly from the contract period. An example is insurance policies for recreational vehicles issued for an annual period, covering claims that are incurred primarily in the summer months. Under other kinds of contracts, the amount of coverage declines over the contract period on a scheduled basis. In those cases, the premium is recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. Unearned premiums, that portion of the premium applicable to the unexpired period of the policy, are included as an unearned premium reserve within the company's balance sheet.

3.33. As discussed in FASB Statement No. 60, some premiums are subject to subsequent adjustment (for example, retrospectively rated or other experience-rated insurance contracts). In these cases, the premium is determined after the period of the contract and is based on claim experience, or reporting-form contracts, for which the premium is adjusted after the period of the contract based on the value of insured property. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the

period of the contract. It should be revised to reflect current experience. However, if the ultimate premium cannot be reasonably estimated, the cost-recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable. Under the cost-recovery method, premiums are recognized as revenue in amounts equal to estimated claims as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until then. Under the deposit method, premiums are not recognized as revenue and claims are not charged to expense until the ultimate premium is reasonably estimable, and income recognition is postponed until that time.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 12 and 14
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 6—Amounts Due From Agents and Brokers*
- *Issue Paper No. 10—Uncollected Premium Balances*
- *Issue Paper No. 50—Classifications and Definitions of Insurance Contracts In Force*
- Minutes of the December 3, 1990 meeting of the Emerging Accounting Issues Working Group

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies, Section 3.32, Revenue Recognition*

State Regulations

- No further guidance obtained from state statutes or regulations.