

FA Module 20: Insurance contracts: GAAP (overview)

(The attached PDF file has better formatting.)

This module covers GAAP for most insurance (and reinsurance) contracts: general insurance, term life, and whole life. Life insurance policies covered by SFAS 97 are not included in this course.

The required readings for this module – annotated paragraphs from SFAS 60 (primary contracts) and SFAS 113 (reinsurance contracts) – are posted on the discussion forum. The readings show selected paragraphs (or parts of paragraphs) from SFAS 60 and SFAS 113 in italics along with explanations in Roman type. The practice problems and illustrations on the discussion forum show the types of final exam questions.

SFAS 60 distinguishes long duration from short duration contracts.

- Long duration contracts are whole life, term life, and most individual health insurance contracts.
- Short duration contracts are general insurance and some group insurance contracts.

Revenue recognition and loss recognition differ by type of contract.

- Short duration contracts: premium is earned and losses are accrued as insurance protection is provided.
- Long duration contracts: premium is earned when due; policy reserves are present values of future claims minus present values of future premiums.

The valuation of insurance costs depends on the type of contract:

- Short duration contracts: future claim payments are valued at ultimate cost (including inflation).
- Long duration contracts: policy reserves are present values, using “locked in” interest rates, mortality rates, morbidity rates, and lapse rates (that is, original assumptions)

The locked-in GAAP assumptions differ from the current IFRS assumptions.

Deferrable acquisition costs are matched to premium revenue.

- Short duration contracts: matching is separate by policy year, even if new business acquisition costs are greater than renewal business acquisition costs.
- Long duration contracts: matching is over the life of the insurance contract. First year acquisition costs are amortized over the life of the contract.

Non-deferrable expenses appear on the income statement; deferrable expenses are capitalized as deferred policy acquisition costs (DPAC) on the balance sheet, which is amortized over the contract life (long duration contracts) or the policy term (short duration contracts).

GAAP conservatism requires that losses may not be deferred after they are anticipated and that income may not be recognized before services are provided. Contracts are grouped by the manner of acquiring, servicing, and measuring profit to determine if a premium deficiency (probable future loss) exists. Probable future losses offset the DPAC asset; any excess is reported as a premium deficiency reserve.

Final exam problems give premiums, acquisition costs, incurred claims, reserve changes, and paid claims for short duration and long duration contracts, and ask for the accounting entries.

Reinsurance premiums and losses form separate assets and liabilities from the primary insurance contracts. Reinsurance contracts must pass SFAS 113 risk transfer tests; otherwise they use deposit accounting. Know the risk transfer tests and the reinsurance accounting rules; the final exam does not test deposit accounting.

Universal life-type contracts with secondary insurance guarantees or embedded derivatives are covered by SFAS 97 and are not included in this course.

Regulation of insurance uses separate statutory accounting in some countries. Some differences between GAAP and statutory accounting are noted in this module but are not tested on the final exam.

