

## FA Module 20: Insurance contracts: GAAP (overview)

(The attached PDF file has better formatting.)

The financial accounting concepts discussed in the previous modules applies to insurers just as to other firms. The rest of the modules in this course deal with procedures that are specific to insurance contracts.

This module covers GAAP for most insurance 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.

The final exam tests GAAP for short duration motor insurance contracts, not for life insurance contracts or for reinsurance contracts. You may skip the readings from SFAS 113 and the long duration contract sections of SFAS 60 without hurting your performance on the final exam.

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. The final exam does *not* test locked-in assumptions vs current 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).

Final exam problems do not expect you to judge which costs are deferrable. For GAAP, agents' commissions and underwriting expenses are deferrable. For IFRS exam problems, all acquisition expenses are deferrable.

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 contracts, and ask for the accounting entries. You are not expected to compute GAAP reserves. Rather, given the GAAP reserves, you will be asked to compute net income.

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. Other actuarial exams cover the risk transfer tests and the reinsurance accounting rules; the final exam does not test reinsurance accounting.

Universal life-type contracts with secondary insurance guarantees or embedded derivatives are covered by SFAS 97 and are not included in this course. Life insurance contracts with multi-year amortization of pre-paid acquisition costs are not tested on the final exam.

Review well the discussion forum posting "FA Module 20 GAAP premium deficiency practice exam questions." the final exam will ask similar problems with different data.

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.