The following are excerpts from the Pool Manager Course

Essentials of Risk Pool Management

Financial and Insurance Components
UNDERSTANDING FINANCIAL REPORTING

Goals of this section:

- Introduce the basic financial statements a pool manager will use
- Describe the basic information each statement provides
- Discuss what the pool manager should consider when reviewing these statements
I. Statement of Net Position

The basic financial reports that a pool manager should use are:

The Statement of Net Position (formally known as the Balance Sheet and Statement of Net Assets)

<table>
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<tr>
<th>ASSETS</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
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Section 3 UNDERSTANDING FINANCIAL REPORTING
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What does this statement tell you?

The Statement of Net Position is like a picture in time. It provides a snapshot of the financial position of the entity at a particular date. It will provide you information on the current balances of the assets: cash, accounts receivable, prepaid expenses, investments and fixed assets. It will also show the balances of the liabilities; accounts payable, unearned revenue and claim liabilities. Finally, the net difference between the assets and the liabilities is the net position.

The Statement of Net Position tells you how much the entity holds in assets, how much are in liabilities and how much are in equity or net position. This statement can be used to assess the pool’s ability to meet its obligations and the amount of net position available to satisfy contingencies.

What should the manager consider when reviewing this statement?

When reviewing the statement of net position it is useful to have a comparative period alongside. This can help you assess how the financial position has changed between periods. The manager should inquire about the nature of significant changes in the balances as compared to the prior year. In addition, the manager should ask whether significant assets and liabilities have been reconciled if trying to make decisions based on the statement of net position.

The basic misconceptions

If you have a lot of cash and investment you are doing well. This is a common misconception that users have when looking at the statement of net position. The true story is the financial position after the liabilities are subtracted from the assets. This shows you what margin remains after the liabilities have been satisfied. The margin or net position balance provides resources in the event the liabilities are increased or to provide for other future needs of the organization. The balance of the net position is not the whole story. The amount represented by net position is simply the difference between the total assets and total liabilities. However, if the entity owns a building, land or equipment, the net amount invested in these assets would be included in the net position balance. But these are not “expendable” assets and should be subtracted if evaluating the “expendable” assets available to satisfy your liabilities.
II. Statement of Revenues and Expenditures

The Statement of Activities (formally known as the Income Statement or Statement of Revenues and Expenses)

Exhibit 3-2

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating Revenues:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Member contributions</td>
<td>$17,630,743</td>
<td>$17,205,012</td>
</tr>
<tr>
<td>Dividends received</td>
<td>-</td>
<td>82,277</td>
</tr>
<tr>
<td>Other income (expense)</td>
<td>6,302</td>
<td>6,899</td>
</tr>
<tr>
<td><strong>Total Operating Revenues</strong></td>
<td>17,637,045</td>
<td>17,294,188</td>
</tr>
<tr>
<td><strong>Operating Expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss and loss adjustment expense</td>
<td>13,053,711</td>
<td>10,619,477</td>
</tr>
<tr>
<td>Claims administration</td>
<td>494,451</td>
<td>462,397</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>1,672,543</td>
<td>1,568,580</td>
</tr>
<tr>
<td>Change in SELF assessment</td>
<td>(380,251)</td>
<td>(36,208)</td>
</tr>
<tr>
<td>Salaries and benefits</td>
<td>1,822,867</td>
<td>1,703,622</td>
</tr>
<tr>
<td>Legal and professional</td>
<td>69,806</td>
<td>57,835</td>
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<tr>
<td>Meeting expense</td>
<td>14,275</td>
<td>14,499</td>
</tr>
<tr>
<td>Outside services</td>
<td>165,836</td>
<td>133,922</td>
</tr>
<tr>
<td>Risk management programs &amp; training</td>
<td>146,996</td>
<td>146,501</td>
</tr>
<tr>
<td>Operations cost</td>
<td>216,470</td>
<td>221,375</td>
</tr>
<tr>
<td>Travel and conferences</td>
<td>47,835</td>
<td>37,676</td>
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<tr>
<td>Depreciation</td>
<td>115,789</td>
<td>122,345</td>
</tr>
<tr>
<td>Dividend expense</td>
<td>648,000</td>
<td>82,277</td>
</tr>
<tr>
<td><strong>Total Operating Expenses</strong></td>
<td>18,088,328</td>
<td>15,134,298</td>
</tr>
<tr>
<td><strong>Operating Income (Loss)</strong></td>
<td>(451,283)</td>
<td>2,159,890</td>
</tr>
<tr>
<td><strong>Non-Operating Revenues and (Expenses)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>419,795</td>
<td>640,878</td>
</tr>
<tr>
<td>Change in fair market value (investments)</td>
<td>285,933</td>
<td>(134,109)</td>
</tr>
<tr>
<td>Rental income</td>
<td>71,610</td>
<td>69,716</td>
</tr>
<tr>
<td>Rental expense</td>
<td>(97,035)</td>
<td>(91,765)</td>
</tr>
<tr>
<td><strong>Net Non-Operating Income</strong></td>
<td>680,303</td>
<td>484,720</td>
</tr>
<tr>
<td><strong>Net Income (Loss)</strong></td>
<td>229,020</td>
<td>2,644,610</td>
</tr>
<tr>
<td><strong>Beginning Net Position</strong></td>
<td>24,012,726</td>
<td>21,368,116</td>
</tr>
<tr>
<td><strong>Ending Net Position</strong></td>
<td>$ 24,241,746</td>
<td>$ 24,012,726</td>
</tr>
</tbody>
</table>
What does this statement tell you?

The Statement of Activities summarizes transactions over a given period. How much money did we earn? How much did we expend? Earning and expending is not the same as receiving and spending. Earning is the amount matched to the period that you have rights to based on satisfying certain requirements. For example, a member could pay their premium before the beginning of the coverage period, i.e. pay the July 1 – June 30th premium on June 15th of the prior year. In this case the premium would not be shown as earned and would not appear on the Statement of Activities as revenue. Instead it would be recorded as cash collected on the Statement of Net Position and a corresponding liability known as unearned revenue. Expenses are recorded in the same manner. The expense is matched to the period that the expense benefits. Insurance premium expense would be recorded in the period of coverage to be provided rather then when the premium is actually paid. This principle of recording revenues and expenses is known as the matching principle. This principle is required to be used under the accrual basis of accounting and helps provide assurance that revenues and expenses and corresponding assets and liabilities are consistently matched against each other in the proper period. Without such a principle, management could forgo paying an expense and not recognize it as a liability and in-turn report a more favorable result of operations.

What should the manager consider when reviewing this statement?

The manager should review the Statement of Revenues and Expenses and compare to the same period last year. The manager should inquire whether significant assets and liabilities have been reconciled. Those adjustments could affect the amounts shown on the statement of revenues and expenses.

The basic misconceptions

A common misconception with the statement of revenues and expenses is that the statement shows what dollars have been spent and what dollars have been collected during the year. As described above for the statement of net position and the discussion in this section on accrual accounting, the statement of revenues and expenses presents what has been earned and what expenses have been incurred during the period. If prior year claims that have already been accrued are paid this year they will not appear on the statement of revenues and expenditures.
III. **Statement of Cash-Flows**

What does this statement tell you?

The statement of cash-flows provides a link between the accrual basis financial statement and the net change in cash and equivalents. This statement is useful in providing management information on where cash resources have been provided and where they have been used. The statement of cash-flows reconciles the net income from operations as recorded on the accrual basis financial statements to the net change in cash for the period.

**Exhibit 3-3**

<table>
<thead>
<tr>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions Received</td>
<td>17,439,523</td>
</tr>
<tr>
<td>Cash Deposits</td>
<td>685,660</td>
</tr>
<tr>
<td>Salaries and Benefits Paid</td>
<td>(1,814,894)</td>
</tr>
<tr>
<td>Other Cash Paid</td>
<td>6,302</td>
</tr>
<tr>
<td>Risk Management Programs &amp; Training Expenses Paid</td>
<td>(146,996)</td>
</tr>
<tr>
<td>Safety Credits Cash Paid</td>
<td>(26,981)</td>
</tr>
<tr>
<td>Dividends Received</td>
<td>-</td>
</tr>
<tr>
<td>Dividends Paid</td>
<td>(648,000)</td>
</tr>
<tr>
<td>Claims Expenses Paid</td>
<td>(11,957,614)</td>
</tr>
<tr>
<td>Premiums Paid</td>
<td>(1,889,206)</td>
</tr>
<tr>
<td>General &amp; Administrative Expenses Paid</td>
<td>(867,615)</td>
</tr>
<tr>
<td><strong>Net Cash Flows Provided (Used) by Operating Activities</strong></td>
<td>780,179</td>
</tr>
<tr>
<td>Acquisition of Capital Assets</td>
<td>9,403</td>
</tr>
<tr>
<td><strong>Net Cash Flows Provided (Used) by Capital &amp; Related Activities</strong></td>
<td>9,403</td>
</tr>
<tr>
<td>Investment Earnings</td>
<td>403,590</td>
</tr>
<tr>
<td>Purchase of Investments</td>
<td>(23,500,000)</td>
</tr>
<tr>
<td>Proceeds from Sales and Maturities of Investments</td>
<td>20,967,236</td>
</tr>
<tr>
<td>Cash Received from Lessees</td>
<td>71,610</td>
</tr>
<tr>
<td>Cash Paid for Rental Expenses</td>
<td>(97,035)</td>
</tr>
<tr>
<td><strong>Net Cash Flows Provided (Used) by Investing Activities</strong></td>
<td>(2,154,599)</td>
</tr>
<tr>
<td><strong>Net Increase (Decrease) in Cash</strong></td>
<td>(1,365,017)</td>
</tr>
<tr>
<td>Beginning Cash and Equivalents</td>
<td>11,324,449</td>
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<td>Ending Cash and Equivalents</td>
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What should the manager consider when reviewing this statement?

It is possible to earn a million dollars for a period but have cash decrease. This could happen if prior claim liabilities are paid down. The claims have already been recorded as an expense in the prior period so when they are paid in the current period cash and the claim liability are both decreased. If this is significant it can reduce the overall cash position even though there were net revenues for the current period.
I. Budget to Actual Financial Statements

What does this statement tell you?

The budget to actual financial statements provide management a measure of how the actual results of operations compare to the planned or budgeted results. This is an important tool in understanding how the organization is performing against its budgeted goals.

What should the manager consider when reviewing this statement?

When reviewing these statements it is important to remember that revenues and expenses do not necessarily occur evenly throughout the year. Interim financial statements may reflect 100% of the excess insurance expense but only a portion of the premium contribution revenue. In addition, the manager should inquire whether important accruals have been calculated and posted in the financial statement being reviewed. Typically, the estimated claims expense and claims liability is not accrued or reconciled for interim periods. Since this is one of the most significant expenses and liabilities it is important for the manager to understand if these amounts are properly recorded when evaluating the results of operations for interim periods.
V. End of Chapter Discussion Topics

1) What basic things should the manager be looking for with reviewing:
   a) The Statement of Net Position
   b) The Statement of Revenues and Expenditures

2) How might a manager compare and relate the financial statements to other information they have received.
   a) Budget
   b) Billing
   c) Actuarial estimates
   d) Claim payments

3) Discuss the principle concepts of accrual basis accounting and how it effects financial reporting.
4) INSURANCE ACCOUNTING

I. Overview of insurance accounting

II. Financial statements
   a. Statement of Net Position Issues
   b. Statement of Activities Issues
   c. Policy year accounting

II. Accounting Standards
   a. FASB; overview
   b. GASB; overview
   c. GASB 10
   d. GASB 30
   e. GASB 31
   f. GASB 34

III. Significant GAAP and GASB Standards as they relate to insurance pools

IV. Claim Schedules

V. Insurance pool coverage

1. End of chapter discussion topics

Appendix:
   • Whose Equity is it? (A discussion of accounting, reporting and member interest in program equity)
   • Common Pool Financial Terms
   • Model Chart of Accounts
I. OVERVIEW OF INSURANCE ACCOUNTING

Goals of this section

- Develop a working understanding of what accrual basis accounting means as it relates to insurance pools.
- Gain an understanding of the key elements of pool financial statements
- Be able to use and understand the elements in the GASB claim reconciliation schedules and loss development schedules

Accrual Based Accounting:
Recording revenue and expense when incurred rather than when it was received or paid. The cash basis of accounting recognizes revenue and expense when it is received or paid.

The basic premise of accrual accounting is to record revenues and expenses in a consistent fashion and to attempt to remove manipulation that could occur through the timing of cash collections and cash payments. As a result we record revenue when earned not collected and expenses when incurred and not when paid. This process also helps meet one of accrual basis of accounting’s principles “the matching principle,” which matches revenues and expenses to the period earned or incurred and matches the revenues to the related expenses.

In insurance accounting, we record the premium revenues over the period of coverage to be provided. We record the corresponding claims expense “incurred” (the amount the actuary estimates will have to be paid out for claims covered under a given policy period.)
II. **FINANCIAL STATEMENTS**

Review the following balance sheet and see what looks familiar compared to financial statements you have seen. An insurance pool’s primary assets are cash and investments and primary liabilities are claims.

**Exhibit 4-1**

**NET POSITION**

Review of a sample insurance pool financial statements

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</tbody>
</table>
a. **Statement of Net Position**

Now let us discuss the components of the balance sheet in a typical pool.

1) Types of Assets
   a. Cash – In banks, trust accounts and local treasuries
   b. Investments – longer-term funds held by the pool or by an investment custodian
   c. Restricted cash or investments (restricted for annuities, state requirements)
   d. Prepaid expenses (insurance)
   e. Deposits with claim administrators
   f. Deposits with mutual insurance companies
   g. Receivables – there are four basic receivables that an insurance pool will typically have; member, interest, insurance and subrogation.
      i. Member; this is typically premium and the deductible portion of claims.
      ii. Interest; for investment income earned during the reporting period but not yet received.
      iii. Excess /Reinsurance; Excess and Reinsurance receivables would be for the covered portion of claims paid that the pool is due reimbursement from the insurance carrier. Definition - GASB-10 a transaction in which an assuming enterprise (reinsurer), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding enterprise). However, the legal rights of the insured are not affected by the reinsurance transaction, and the ceding enterprise issuing the original insurance contract remains liable to the insured for payment of policy benefits.

   (Guidance)
   GASB-10, paragraph 37, Amounts that are recoverable from reinsurers or excess insurers and that relate to paid claims and claim adjustment expenses should be classified as assets (with an allowance for estimated uncollectible amounts) and as reductions of expenses. Estimated amounts recoverable from reinsurers that relate to liabilities for unpaid claims and claim adjustment expenses should be deducted from those liabilities rather than reported as assets. Unearned premiums on contracts ceded to a reinsurer by a pool should be netted with related premiums paid to but not yet earned by the reinsurer. Receivables and payables from the same reinsurer, including amounts withheld, also should be netted. Reinsurance premiums paid and reinsurance recoveries on claims may be netted against related earned premiums and incurred claims costs, respectively, in the operating statement.

   (Guidance)
GASB-10 Paragraph 38, Proceeds from reinsurance transactions that represent recovery of acquisition costs should reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized. If the pool has agreed to service all of the related ceded insurance contracts without reasonable compensation, a liability should be accrued for estimated excess future servicing costs (maintenance costs) under the reinsurance contract.

(Guidance)
GASB-10 Paragraph 39, To the extent that a reinsurance or excess insurance contract does not, despite its form provide for indemnification of the pool by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer should be accounted as a deposit by the pool. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the pool is a deposit, amounts paid should be accounted for as deposits. A net credit resulting from the contract should be reported as a liability by the pool.

iv. Subrogation; this is the amount collectable from a responsible third party for claims paid. (we say for the claims paid portion because if it is only incurred, the expected subrogation part of claims incurred is not recorded for a governmental insurance pool) You would only record a subrogation receivable for payments you made on claims but expect recovery from a responsible third party.

h. Property and Equipment; this is the net capitalized portion of furniture, computers, equipment, land and buildings (net of accumulated depreciation)
2) Types of Liabilities

a. Accounts payable; this should only include the normal trade and operational expenses payable. Note: The accountant should not include claims presented for payment in the accounts payable account if that amount has already been provided for in the overall loss estimate recorded in the claims liability section.

b. Unearned income (unearned but collected); typically this would be the unexpired portion of premium revenue collected. (this is discussed further in the premium contribution section).

c. Claims payable; GASB-10 defines the Liability for unpaid claims costs as the amount needed to provide for the estimated ultimate cost of settling claims for events that have occurred on or before a particular date (ordinarily, the balance sheet date). The estimated liability includes the amount of money that will be needed for future payments on both (a) claims that have been reported and (b) incurred but not reported (IBNR) claims.

d. Reserves payable; these are the amounts estimated by claims examiners on reported claims.

e. IBNR (Claims Incurred But Not Reported)

Incurred but not reported (IBNR) claims for insured events that have occurred but not yet reported to the governmental entity, public entity risk pool, insurer, or reinsurer as of the date of the financial statements. IBNR claims include (a) known loss event that are expected to later be presented as claims, (b) unknown loss events that are expected to become claims, and (c) expected future development on claims already reported.

The estimated liability is evaluated typically through a periodic actuary study that reviews whether cumulative payment activity and known but unsettled claims may indicate that estimated future costs may be more or less than originally projected.

(i) Discounting Claims

GASB-10 paragraph 24, The practice of presenting claims liabilities at the discounted present value of estimated future cash payments (discounting) is neither mandated nor prohibited. However, claims liabilities associated with structured settlements should be discounted if they represent a contractual obligations to pay specific amounts on fixed or determinable dates. GASB-10 Paragraph 25, If claims liabilities are discounted, the pool should use a rate that is determined by giving consideration to such factors as the pool’s settlement rate for those liabilities and its investment yield rate.
Should you discount or not?

The premise behind discounting claims is that premium funds held can grow to meet the future cash-flow needs to settle claim payments as they come due. These funds are typically invested and can grow to meet the claim obligation. In theory you can collect 80 cents today to pay $1 of claims in the future. As a result if you have your actuary provide discounted outstanding claims liabilities, you can more accurately state your financial position.

What is the down side of discounting?

Discounting is less conservative in stating the carrying balance of your claim liabilities and your overall financial position. Discounting carries additional assumptions attached to claim liabilities that already are based on many estimates and assumptions. Discounting requires that an assumed rate of return on investments be calculated and relies on an assumed payout pattern. If any of these changes significantly then the pool’s financial position may be affected. If you assume you will earn 7% on your investments then your claim liabilities would be discounted more than if you discount at 5%. If you fund your claim liabilities at a discounted rate and you earn less or you pay claims sooner than expected and you would not have the funds invested and earning as long as expected, investment revenues may be insufficient to cover the difference between the undiscounted claims and the discounted claims.
What do most pools do?

In my experience, about 75% of insurance pools discount their claims. Most pools have a stable loss history where payment patterns can be predicted by the actuary and if the assumed earnings rate is sufficiently conservative then the ultimate earnings on investments should be sufficient to cover the discounting spread.

When is discounting not a good policy?

If payment patterns tend to be unstable and less predictable (as could be the case with some small excess layer insurance pools), earnings have been unstable, or there are deficits in the funding; (so the cash and investments are not on hand to provide the earnings assumed in the discounting formula). The more volatile your claims are the less value discounting is to your loss estimate.

f. ALAE (Allocated Loss Adjustment Expenses)
   (i) GASB-10 ..those expenses that can be associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees.

g. ULAE (Unallocated Loss Adjustment Expenses)
   (i) Claim expenses should include all costs both allocated and unallocated when estimating and recording the liability and related expense. GASB-10-...

unallocated expenses included claim adjustment expenses, which are other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as salaries and other internal costs of the pool’s claims department.

h. Whether a cost is ALAE or ULAE depends on whether that cost is directly allocated to each particular claim.

i. Salvage and Subrogation;
   (i) Salvage is the amount the pool may recover from the sale of the damaged property which would reduce the net loss cost when this revenue is recorded against the claim cost.
   (ii) Subrogation is the right of the insurer to stand in the place of the claimant to recover against a third party (who is liable) any damages in the policyholder’s name.
Understanding Unallocated Loss Adjustment Expenses (ULAE) and establishing a reserve for the related liability:

Unallocated Loss Adjustment Expenses

by John E. Chaquica, MBA, CPA
and James P. Marta, CPA

Just when you thought you knew GASB 10 inside and out, someone asks you, "How do you calculate your ULAE?"

Based on our experience, your answer is probably one of the following:
"My what?"
"Oh, I don't have any."
"It's the members' responsibility."
"We figured $25,000 should do."

These answers aren't fiction; pools are using quite a range of accounting applications to determine their liability for unallocated loss adjustment expense (ULAE). Determining the best method depends on the nature of the pool and its operations.

What Are ULAE’s?

Unallocated claims expenses are costs not specifically associated with particular claims but related to claims paid or settlements. These are ULAE’s; examples are:

- Claims administration costs, if not determined on a claim-by-claim basis or direct-time charge.
- General continuing administration costs such as a full- or part-time manager; board meeting expenses; accounting, audit and annual reporting overhead (rent, depreciation, utilities, etc.).
- General legal counsel.
- Actuarial studies.

Dividends, loss control, excess insurance and underwriting expenses are not considered unallocated claims expenses.

Unallocated claims expenses are often referred to as run-out expenses because they represent the costs to ultimately run-out (settle) claims. Many pools aren't reflecting a liability for the unallocated expenses when this liability could be substantial.

Pools usually have actuaries help establish an estimate of claims liability. Once you have an estimate, record the amount as a liability. Although you may not settle these claims for many years, record the estimated expense in the year you incurred the claim. This matches revenue (premium/contributions) with expense (claims) in accordance with generally accepted accounting practices (GAAP). Because the actuary and the claims administrator only include the allocated expenses in their estimate of outstanding claims liability, you often need to determine the related ULAE liability. Alternatively, you could provide the necessary data to the actuary to make an estimate, since the actuary should review the amount in conjunction with determining the necessary funding level. When establishing your liability for ULAE, identify what unallocated expenses you incur, and determine a relationship between the claims expenses and the ULAE. To identify the unallocated
expenses, only consider expenses necessary to settle claims, not ongoing pool expenses. Ask yourself, "What expenses would continue if we only had to settle prior claims and the pool had no other continuing operations?" The nature of these expenses may depend on the type of claims being settled and the period over which the claims will run-out.

For example, medical benefit claims may take from three months to three years to run-out, but workers' compensation claims

Workers' Compensation Fund Calculation of Reserve for Unallocated Expense

<table>
<thead>
<tr>
<th>Unallocated Expenses:</th>
<th>6/30/00</th>
<th>6/30/01</th>
<th>6/30/02</th>
<th>6/30/03</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Management</td>
<td>$58,000</td>
<td>$66,000</td>
<td>$146,000</td>
<td>$224,000</td>
<td>$494,000</td>
</tr>
<tr>
<td>Other</td>
<td>42,000</td>
<td>110,000</td>
<td>198,000</td>
<td>48,000</td>
<td>398,000</td>
</tr>
<tr>
<td>Claims Administration'</td>
<td>300,000</td>
<td>595,000</td>
<td>752,000</td>
<td>9580000</td>
<td>2,805,000</td>
</tr>
<tr>
<td>Total</td>
<td>$600,000</td>
<td>$771,000</td>
<td>$1,096,000</td>
<td>$1,230,000</td>
<td>$3,697,000</td>
</tr>
<tr>
<td>Total Claims Paid</td>
<td>$5,800,000</td>
<td>$16,600,000</td>
<td>$9,800,000</td>
<td>$7,700,000</td>
<td>$39,900,000</td>
</tr>
<tr>
<td>Percent of Unallocated Expense to Claims Paid</td>
<td>10.34%</td>
<td>4.64%</td>
<td>11.18%</td>
<td>15.97%</td>
<td>9.26%</td>
</tr>
</tbody>
</table>

Unallocated Expense Factor Used is 9.50%

Calculated @ June 30, 2003:

<table>
<thead>
<tr>
<th>for:</th>
<th>Times</th>
<th>Times</th>
<th>Equals Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claims</td>
<td>$14 million</td>
<td>9.5%</td>
<td>50%</td>
</tr>
<tr>
<td>IBNR</td>
<td>$4.5 million</td>
<td>9.5%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Calculated Unallocated Loss Adjustment Expense @ June 30, 2003 $1,092,500

*The above is used to estimate the average claims administration cost and was based on the actual claims paid as compared to the actual costs to estimate the future costs to administer outstanding claims*

*Claims administration may be an allocated claims expense if it is paid on a per-claim or percentage-of-paid-claims basis. Our example assumes it is a flat fee annual contract, making it an unallocated expense.*

In this example, IBNR is multiplied times the full ULAE factor, but reserves are only multiplied by 50 percent of the ULAE factor. We did this because we estimated, on average, once a particular claim is known and a claim file established, half of the ULAE expenses would have already been incurred, these claim adjusting expenses may take 14 years or more years to run-out. We believe the pool manager is best suited to determine which expenses are likely to continue. As pool manager, you're most familiar with the pool's unique operating characteristics, and you have the necessary internal information.

Once you've identified unallocated expenses, decide whether the amount is material in dollar amounts to your program. If so, then the real work starts. It's now time to determine a rational method to calculate the liability. As shown above, one method is to relate the ULAE to the claims liability. Use prior experience and financial data to determine the ULAE on a per-claim or per-dollar basis.

Follow these steps:

1. Identify unallocated expenses (ULAE).
2. Compare the ULAE to total claims expense to determine it as a percent of claims paid.
3. Select an average rate.
4. Multiply this rate by the liability for claims expenses (reserves and incurred but not reported).

This approach is a typical one similar to any overhead cost allocation. Therefore, once calculated, you need to step back and look at it from a reasonableness standpoint to see that it makes sense. An important note is that the accuracy of your estimate can vary based on the ultimate dollar value of claims, the number of claims, changing legal, and industry-related factors.

Planning For Settlement Costs

The ULAE amount will vary greatly if the pool is ceasing operations. GAAP, however, requires you to prepare financial statements on the assumption that the entity is a going concern, unless the entity is not. If the pool is winding down, the settlement costs per claim may increase greatly. This is due to the economies of scale from administering a large quantity of claims. If you use a claims administrator, you may have to pay a premium price to run-out the remaining claims since the more troublesome claims tend to be processed last, and you may have to pay increased wages to claims processors and managers since the position has no long-term future.

If you expect to be in a wind-down situation, you should think about run-out financing techniques. If the pool has built into the claims administration contract specific amounts to run-out all claims or a separate contract for this possibility, you’ll obviously find it easier to estimate this cost. If the contract is silent on this, think about the potential impact. Other options include paying a lump sum to an insurance carrier to settle all outstanding claims during the wind-down phase.

Current accounting standards require you to recognize ULAE as a liability. It’s an important step in ensuring a pool’s financial stability. Don’t ignore it.
b. Statement of Activities

Review the following income statement and see what looks comparable to financial statements you have seen and look at the major revenue and expense items.

Exhibit 4-2

<table>
<thead>
<tr>
<th>STATEMENT OF ACTIVITIES</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating Revenues:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Member contributions</td>
<td>$17,630,743</td>
<td>$17,205,012</td>
</tr>
<tr>
<td>Dividends received</td>
<td>-</td>
<td>82,277</td>
</tr>
<tr>
<td>Other income (expense)</td>
<td>6,302</td>
<td>6,899</td>
</tr>
<tr>
<td><strong>Total Operating Revenues</strong></td>
<td>17,637,045</td>
<td>17,294,188</td>
</tr>
<tr>
<td><strong>Operating Expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss and loss adjustment expense</td>
<td>13,053,711</td>
<td>10,619,477</td>
</tr>
<tr>
<td>Claims administration</td>
<td>494,451</td>
<td>462,397</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>1,672,543</td>
<td>1,568,580</td>
</tr>
<tr>
<td>Change in SELF assessment</td>
<td>(380,251)</td>
<td>(36,208)</td>
</tr>
<tr>
<td>Salaries and benefits</td>
<td>1,822,867</td>
<td>1,703,622</td>
</tr>
<tr>
<td>Legal and professional</td>
<td>69,806</td>
<td>57,835</td>
</tr>
<tr>
<td>Meeting expense</td>
<td>14,275</td>
<td>14,499</td>
</tr>
<tr>
<td>Outside services</td>
<td>165,836</td>
<td>133,922</td>
</tr>
<tr>
<td>Risk management programs &amp; training</td>
<td>146,996</td>
<td>146,501</td>
</tr>
<tr>
<td>Operations cost</td>
<td>216,470</td>
<td>221,375</td>
</tr>
<tr>
<td>Travel and conferences</td>
<td>47,835</td>
<td>37,676</td>
</tr>
<tr>
<td>Depreciation</td>
<td>115,789</td>
<td>122,345</td>
</tr>
<tr>
<td>Dividend expense</td>
<td>648,000</td>
<td>82,277</td>
</tr>
<tr>
<td><strong>Total Operating Expenses</strong></td>
<td>18,088,328</td>
<td>15,134,298</td>
</tr>
<tr>
<td><strong>Operating Income (Loss)</strong></td>
<td>(451,283)</td>
<td>2,159,890</td>
</tr>
<tr>
<td><strong>Non-Operating Revenues and (Expenses)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>419,795</td>
<td>640,878</td>
</tr>
<tr>
<td>Change in fair market value (investments)</td>
<td>285,933</td>
<td>(134,109)</td>
</tr>
<tr>
<td>Rental income</td>
<td>71,610</td>
<td>69,716</td>
</tr>
<tr>
<td>Rental expense</td>
<td>(97,035)</td>
<td>(91,765)</td>
</tr>
<tr>
<td><strong>Net Non-Operating Income</strong></td>
<td>680,303</td>
<td>484,720</td>
</tr>
<tr>
<td><strong>Net Income (Loss)</strong></td>
<td>229,020</td>
<td>2,644,610</td>
</tr>
</tbody>
</table>

Now let us look at the components of the statement of activities.

1) Revenues
   a. Accounting for premium related revenues
      (i) Contributions (not premiums) They represent the estimated share of the pooled losses for a given policy year.
(ii) Recognition of contribution revenues; premium contributions should be recognized over the period of risk protection provided by the insurance pool. For example; if the pool has a June 30 year-end and has a policy period beginning January 1, six months of the insurance premium would be recorded as earned revenue and the remainder would be unearned. The same concept would apply to a multi-year premium where only the portion relating to the current reporting period would be recorded as revenue and the balance unexpired as a liability (unearned or deferred revenue).

(iii) Contribution credits or discounts; these should be recorded as a component of contribution revenue. It may be wise to separately reflect these so that users could see and appreciate the credits or discounts provided.

(iv) Contributions may be subject to adjustment as with retrospectively rated contracts, in this case, contribution revenue should be revised in the period of re-estimate.

(v) Premium Deficiency; GASB-10, paragraph 34, A probable loss on insurance or pool participation contracts exists if there is a premium deficiency. Contracts should be grouped consistent with the pool’s manner of acquiring, servicing, and measuring the revenue and expense elements of its contracts to determine if a premium deficiency exists.

Paragraph 35, A premium deficiency should be recognized if the sum of expected claims costs (including IBNR) and all expected claim adjustment expenses, expected dividends to policyholders or pool participants, unamortized acquisition costs and incurred policy maintenance costs exceeds related unearned premiums. (Pools are required to disclose whether anticipated investment income is considered in determining if a premium deficiency exists.)

Paragraph 36, if a premium deficiency exists, unamortized acquisition costs should be expensed to the extent of the deficiency. Deficiencies resulting from risk-sharing pool participation contracts should also be reported as revenue and assessments receivable at the time the pool determines that a deficiency is reasonably estimable, provided the pool has an enforceable legal claim to the amounts and their collectability is probable and reasonably estimable.

So what do these three paragraphs mean? If you have unearned premiums and you have net losses that create a premium deficiency related to those unearned premiums then you should recognize as revenue those unearned premiums to the extent that there is a premium deficiency.
For example; if you had a property program that had a program year of January 1 to December 31 and you have a fiscal year end of June 30; additionally if you had a large loss in the first six months of that policy period that is expected (with other related expenses) to exceed the earned portion of premiums, then you would recognize the unearned portion of premium income to cover the premium deficiency.

Why does this make sense?
Premium revenue is recognized prorata over the policy period, however, losses do not always occur on such an even basis. Most of your losses could occur in the first six months of a policy period. The premium deficiency accounting recognizes that this occurs and provides for the matching of the premium revenue to the expected deficiency.

Risk Sharing Pool Premiums

In a risk sharing pool, premiums are collected through an underwriting process where a combination of exposure and experience is used to establish each member’s contribution. Once that amount is determined, claims from that policy year are paid from the pool of premiums collected. In a pure risk sharing pool an individual member may be assessed for their pro rata portion of pooled losses even if they (the individual member) had no actual losses for that policy year. (see the following chart)
Exhibit 4-3

Summary of flow of pooled premiums and pooled expenses for a risk sharing pool

Contributions

Plus

Member 1
Member 2
Member 3
Member 4
Member 5

Pooled Contributions

Member contributions vary according to individual member rating and undewriting factors.

Plus

Investment Earnings

Less

Pooled Operations

Less

Excess Insurance

Less

Pooled Losses

Less

Losses

Less

Losses

Less

Losses

Less

Losses

Less

Losses

Less

Losses

Plus or Minus

Assessments

Dividends

Equals

Calculated surplus

Surplus is the excess contributions collected for the policy year

Amounts available represent the excess of the contributions collected for the pool from each member over the amount needed to satisfy pooled claims.
b. Dividends received; these are typically from excess carriers or excess pools that return dividends. These are normally recorded in the period received unless you have been formally notified that a dividend has been approved and is forthcoming. In that case it would be recorded in the period that is approved by the granting entity.

c. Assessments (against participants); these are additional contributions required for funding self-insured losses. Assessments should be recorded when:
   (i) The amount is approved by the governing body, or
   (ii) Is otherwise determined and “enforceable” according to the agreement, and
   (iii) The amount to be assessed is determined

d. Investment income; (interest dividends, change in fair value of investments. (GASB 31) Why does change in market value make sense?
   (i) Investment income is recorded in the period earned; not just collected, so interest and dividends earned but not received by the end of the reporting period should be recorded as revenue in the current period.
   (ii) Governmental insurance pools are required to record investment balances at market value to reflect the liquidity value of assets available to settle claims. Any adjustments up or down in the current period of the net market value should be reported as a component of investment income.

e. Non-operating income; this includes nonprogram related revenues, typically rental income for entities that own buildings and lease out space.
2) Expenses

a. Claims expense and how to reflect it on the financial statements.

Claims costs should be recorded in accordance with criteria required under Financial Accounting Standards Board Statement Number 5 (Accounting for Contingencies); where estimated losses should be accrued when:

- It is probable that the loss has occurred at the date of the financial statements.
- The amount of the loss can be reasonably estimated.

(the cost occurs when the covered event occurs and the resulting loss cost is *incurred*.)

The components of the loss costs are as follows:

(i) Paid claims

(ii) Accrual of reserves and IBNR; GASB-10 paragraph 22, ...Claim accruals for IBNR claims should be made if it is **probable** that a loss has been incurred and the amount can be reasonably estimated.

(iii) Changes in loss estimates; GASB-10 paragraph 22, ...*Changes in estimates of claims costs resulting from the continuous review process and differences between estimates and payments for claims should be recognized in the results of operations of the period in which the estimates are changed or payment are made.*

(iv) Grouping allocated loss adjustment and unallocated loss adjustment expenses.

(v) Recoveries; under GASB-10, loss costs should be reported net of recoveries.

b. Excess and reinsurance: this is the purchased insurance beyond the covered layer (excess insurance) or to cover a portion of your layer (reinsurance). Excess and reinsurance costs should allocated on a prorata basis to the period of coverage. This is typically the second largest expense after claims expense.

c. Risk management: Accounts for cost of providing members risk management services that may include loss control activities and wellness program activities. Examples would include 'proper lifting' training.

d. Claims administration: accounts for the internal or external direct claims handling costs

e. Safety and loss control: may be a separate expense category from risk management if there are specific ongoing safety and loss control programs.

f. General administration: Accounts for costs associated with the administration and operation of the insurance pool and may include accounts that also appear in the 'General & Administrative’ account classification. Such costs would include
salaries/benefits, actuarial services, printing of program materials/brochures and program specific audits.

g. Dividends: (policyholder dividends) GASB-10; paragraph 32, A policy holder dividend (or return of contributions), as distinguished from an experience refund (paragraph 33), is not determined based on the actual experience of an individual policyholder or pool participant but is instead based on the experience of the pool or of a class of policies. Policyholder dividends should be accrued as dividends expense using an estimate of the amount to be paid. Dividends used by policyholders to reduce premiums should also be reported as premium income. Policy holder dividends include amounts returned to pool participants from excess premiums for future catastrophe losses (paragraph 21).

A policyholder dividend should be recorded in the period it is approved by the board. When the amount is determined the dividend expense is recorded and a corresponding liability for dividends payable is recognized. It is typical for pools to approve a dividend in one period with a payment to occur in a subsequent period. When the amount is determinable it becomes an expense and liability of the pool. In certain circumstances, a dividend policy approved by the board may require the recognition of a dividend upon the meeting of certain criteria.

Experience Refunds; GASB-10; paragraph 33, Experience refunds are based on the experience of individual policyholders or pool participants. If experience refund arrangements exist under experience-rated contracts, a separate liability should be accrued for those amounts, based on experience and the provisions of the contract. Revenue should be reduced by amounts that are expected to be paid in the form of experience refunds.

c. Policy year accounting issues

Fiscal year accounting versus policy year accounting;

- A fiscal year is the pool’s accounting year. For governments this is typically July 1 through June 30 but it could be any twelve-month period.

- A policy year is the year of coverage and this could be different than the fiscal year. For example, a pool could have a June 30th fiscal year but have a December 31st policy year for one of its programs.

In most cases pools have fiscal and policy year-ends that are the same. Once the fiscal year ends, the accounting of the policy year results will continue until all claims have been settled and the equity disbursed or allocated. After the end of the normal fiscal year a policy year is still active making claim payments, earning interest on premium dollars invested and the ultimate claim costs are being re-estimated based on loss development and the related actuarial estimates.
Many pools refer to amounts paid by members as *Contributions* because this is not insurance. The contribution made by a member is the estimated cost of coverage and the ultimate cost will be known when the pool has settled out its final claims. Most pooling agreements have provisions to assess members for additional contributions if needed or to dividend back to members’ excess contributions collected. Pools typically maintain a separate accounting of the policy year balances to determine the sufficiency of the policy year funding and to allocate related investment earnings.
III. ACCOUNTING STANDARDS

For starters we need to define the acronyms GAAP, FASB and GASB.

GAAP (Generally Accepted Accounting Principles) consist of the financial accounting and reporting assumptions, standards, and practices that an entity must use in preparing external financial statements. Generally accepted accounting principles are prescribed by authoritative bodies, such as the FASB (Financial Accounting Standards Board) and the GASB (Governmental Accounting Standards Board), and are based on theoretical and practical considerations. These standards represent a consensus among accountants as to what is considered acceptable practice.

These standards change over time in response to changes in the economic environment and the needs of financial statement users. For example, GASB statement No. 31 Accounting and Financial Reporting for Certain Investments and External Investment Pools, effective after June 15, 1997 changed the accounting and reporting for investments to require that investments be reported at market value. This standard was in response to the concern that the amortized cost method did not adequately present long-term debt securities that had market value declines due to other-than-temporary conditions.

Financial accounting and reporting require many estimates, assumptions, and professional judgment. As a result, personal bias, misassessment of the facts and differences in estimation may affect the measurement of economic events. It is essential that financial statements have credibility to the users. Without consistent application of standards, each accountant would have to develop his or her own accounting. With differences in judgments and accounting principles it would be difficult to compare financial results and positions between entities and between fiscal years. This is why strict application of GAAP, GASB and applicable accounting standards are required.

Accounting standards are established by two principal entities, the FASB and the GASB, these entities are made of a board of professional and educational specialists.
a. FASB; overview
Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979). Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information.

The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission’s policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

THE MISSION OF THE FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

The mission of the Financial Accounting Standards Board (FASB) is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information.

Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information. Financial information about the operations and financial position of individual entities also is used by the public in making various other kinds of decisions.

To accomplish its mission, the FASB acts to:

- Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;
- Keep standards current to reflect changes in methods of doing business and changes in the economic environment;
- Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;
- Promote the international convergence of accounting standards concurrent with improving the quality of financial reporting; and
- Improve the common understanding of the nature and purposes of information contained in financial reports.

The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards. Concepts are useful in guiding the Board in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework will help to establish reasonable bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports. It also will help the public to understand the nature and limitations of information supplied by financial reporting.

The Board’s work on both concepts and standards is based on research aimed at gaining new insights and ideas. Research is conducted by the FASB staff and others, including foreign national and international accounting standard-setting bodies. The Board’s activities are open to public participation and observation under the "due process" mandated by formal Rules of Procedure. The FASB actively solicits the views of its various
constituencies on accounting issues.

The Board follows certain precepts in the conduct of its activities. They are:

- **To be objective in its decision making** and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.
- **To weigh carefully the views of its constituents** in developing concepts and standards. However, the ultimate determinant of concepts and standards must be the Board’s judgment, based on research, public input and careful deliberation about the usefulness of the resulting information.
- **To promulgate standards only when the expected benefits exceed the perceived costs.** While reliable quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits.
- **To bring about needed changes in ways that minimize disruption to the continuity of reporting practice.** Reasonable effective dates and transition provisions are established when new standards are introduced. The Board considers it desirable that change be evolutionary to the extent that it can be accommodated by the need for relevance, reliability, comparability and consistency.
- **To review the effects of past decisions** and interpret, amend or replace standards in a timely fashion when such action is indicated.

The FASB is committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on financial information. The Board believes that this broad public interest is best served by developing neutral standards that result in accounting for similar transactions and circumstances in a like manner and different transactions and circumstances should be accounted for in a different manner.

### b. GASB; overview

The Governmental Accounting Standards Board (GASB) was organized in 1984 by the Financial Accounting Foundation (FAF) to establish standards of financial accounting and reporting for state and local governmental entities. Its standards guide the preparation of external financial reports of those entities. The Foundation is responsible for selecting the members of the GASB and its Advisory Council, funding their activities, and exercising general oversight (except with regard to the GASB’s resolution of technical issues).

The GASB’s function is important because external financial reporting can demonstrate financial accountability to the public and is the basis for investment, credit, and many legislative and regulatory decisions.

**The Mission of the Governmental Accounting Standards Board**

The mission of the Governmental Accounting Standards Board is to establish and improve standards of state and local governmental accounting and financial reporting that will:

- Result in useful information for users of financial reports and
- Guide and educate the public, including issuers, auditors, and users of those financial reports.

**Uses and Users of Governmental Accounting and Financial Reporting**

Accounting and financial reporting standards are essential to the efficient and effective functioning of our democratic system of government:

- Financial reporting plays a major role in fulfilling government's duty to be publicly accountable.
• Financial reporting by state and local governments is used to assess accountability and to make economic, social, and political decisions.

The primary users of state and local government financial reports are those:
• To whom government is primarily accountable--its citizens,
• Who directly represent the citizens--legislative and oversight bodies, and
• Who finance government or who participate in the financing process--taxpayers, other governments, investors, creditors, underwriters, and analysts.

Government administrators also are users of financial reports; whether they are considered primary users depends on whether they have ready access to internal information.
The Government Accounting Standards Board (GASB) establishes accounting and financial reporting guidance for governmental entities. The GASB issued several statements that relate to insurance pools. These statements provide the necessary guidance for accounting standards for governmental insurance pools. It should be noted that subsequent statements issued by the GASB may modify or replace the standards described in these statements.

The Governmental Accounting Standards Board (GASB) has issued four standards that have a significant effect on the accounting and reporting for insurance pools.

c. **GASB Statement 10**

**ACCOUNTING AND FINANCIAL REPORTING FOR RISK FINANCING AND RELATED ISSUES**

*Issued November 1989*

This statement establishes accounting and financial reporting standards for risk financing and insurance-related activities of state and local government entities, including public entity risk pools. Specific guidance includes but is not limited to:

- Revenue recognition
- Claim cost accounting
- Financial statement disclosures required for public entity risk pools
- Required supplementary information:
  - Reconciliation of unpaid claim liabilities by type of contract
  - Ten-year claims development information

*Effective date for periods beginning after June 15, 1990*
d. GASB Statement 30

RISK FINANCING OMNIBUS
An amendment of GASB Statement 10

Issued February 1996

This statement amends GASB Statement 10, Accounting and Financial Reporting for Risk Financing and Related Insurance Issues, for public entity risk pools.

For public entity risk pools, this Statement:

- Modifies the method for calculating a premium deficiency
- Requires disclosure about the type of reinsurance or excess insurance coverage
- Modifies the presentation of the ten-year claims development schedule to include gross, ceded, and net premiums and claim costs.
- Provides that claims development information should be reported consistently on an accident-year basis, report year-basis, or a policy-year basis.

Effective date for periods beginning after June 15, 1996

e. GASB Statement 31

ACCOUNTING AND FINANCIAL REPORTING FOR CERTAIN INVESTMENTS AND FOR EXTERNAL INVESTMENT POOLS

Issued March 1997

This statement establishes accounting and financial reporting standards for all investments held by governmental external investment pools. For most other governmental entities, it establishes fair value standards for investments in:

- Interest-earning investment contracts
- External investment pools
- Open-ended mutual funds
- Debt securities
- Equity securities

Fair value is the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.
As the statement relates to public entity risk pools, it amends Statement 10, paragraphs 40, 41, 44, 46, and 47

Effective date for periods beginning after June 15, 1997

f. GASB Statement 34

BASIC FINANCIAL STATEMENTS – AND MANAGEMENT’S DISCUSSION AND ANALYSIS – FOR STATE AND LOCAL GOVERNMENTS

Issued June 1999

This statement establishes accounting and financial reporting standards for state and local governments. It establishes that the basic financial statements and required supplementary information (RSI) for general purpose governments should consist of:

- Management’s discussion and analysis (MD&A). MD&A should introduce the basic financial statements and provide an analytical overview of the government’s financial activities. Although it is RSI, governments are required to present MD&A before the basic financial statements.

Changes as they would relate to insurance pools

- The basic financial statements of enterprise fund types (JPA’s) would change very little with the implementation of GASB 34. The principle changes are the requirement of the direct method for the statement of cash-flows and the reporting of designations of retained earnings would not be displayed on the face of the financial statements but instead would be displayed in the footnotes
Effective date for periods beginning after June 15, 1999, Phased in as follows:

Governments with total annual revenues exceeding:

100 million should apply this for periods beginning after June 15, 2001

10 million but not more than 100 million should apply this for periods beginning after June 15, 2002.

Less than 10 million should apply this for periods beginning after June 15, 2003

For complete copies of these statements visit: www.gasb.org/pronouncements

In addition to the Statements, certain implementation guides and question and answer summaries may be available.
IV. **SIGNIFICANT GAAP AND GASB STANDARDS AS THEY RELATE TO INSURANCE POOLS**

Questions often come up about how to treat certain transactions or what disclosures may be required. The following are common areas that are frequently questioned.

**Investments Must be Reported at Fair Market Value**

Investments are required to be reported at fair market value as of the date of the financial statements. GASB 31.

**Reporting Claims Must be Net of Excess or Reinsurance**

Governmental insurance accounting under GASB differs from standard insurance accounting under FASB because it requires that claim liabilities be reported net of excess or reinsurance layers. If a claim is paid in an excess layer a receivable should be established for the excess portion. If the actuarial and claims reporting do not properly report claims net of excess and reinsurance liabilities could be significantly overstated.

**What standards require recording of claim liabilities**

*Warning, the following is the technical support for recording the liabilities. You need to record claim liabilities. If you don’t believe me, study the section below.*

FAS No. 5 - *Accounting for Contingencies* - (July, 1975)

FAS No. 5 defines the criteria for accruing loss contingencies. Loss contingencies shall be accrued if both of the following conditions are met:

a. Information available prior to the issuance of financial statements indicates that it is probable that an asset has been impaired or that a liability has been incurred at the balance sheet date

b. The amount of the loss can be reasonably estimated.

This statement defines the thresholds for loss estimation as either probable, reasonably possible or remote. These terms are used in later statements including FAS No. 113 paragraph 9.b. in defining indemnification (risk transfer) in reinsurance contracts.

Paragraphs 40 through 43 of FAS No. 5 addressed the conditions upon which a (re)insurance company should accrue losses on assumed (re)insurance.

Paragraph 44 of FAS No. 5 provided early guidance on indemnification, risk transfer and deposit accounting for situations where an insurance or reinsurance contract, despite its form, does not transfer insurance risk.

Paragraph 66 of FAS No. 5 addressed the unique quality of indemnity based (re)insurance contracts to provide “a more stable pattern of reported earnings.”

FAS No. 60 – *Accounting and Reporting by Insurance Enterprises* – (December, 1982)

FAS No. 60 extracted the specialized accounting principles and practices from the AICPA Audit Guides and Statements of Position (SOP) to establish financial and reporting guidance for all insurance enterprises other than mutual life insurance enterprises and fraternal benefit societies. The statement requires that
insurance contracts be classified as either short-duration (primarily property casualty contracts) or long-duration contracts. The statement provides accounting rules that differ based on whether the contract is short or long duration.

This statement is comprehensive as it addresses revenue and expense recognition, deferral of acquisition costs, premium deficiency reserves, measurement of assets and liabilities and accounting for investments among other issues.

This statement codified industry practice of net accounting. Under net accounting, reinsurance recoverable on paid claims is classified as an asset, but reinsurance recoverable on unpaid claims and claims expenses and unearned premium reserves are deducted from gross unpaid claims and claims expenses and gross unearned premium reserves as a contra liability. **FAS No. 113 superseded this guidance and eliminated net accounting on the balance sheet for GAAP but not for GASB purposes.**

Paragraph 7a. of FAS No. 60 defines a short-duration contract as a contract that provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided. Contemporaneously with the development of EITF 93-6 the SEC expressed the view that they may challenge the classification of any short-duration contract with greater than a three-year term.

Paragraphs 38 through 40 and 60(f) addressed indemnification, risk transfer and deposit accounting for reinsurance contracts that provide indemnification and provided guidance for reinsurance contracts that do not provide indemnification. **FAS No. 113 superseded this guidance.**

**FAS No. 113 – Accounting and Reporting for Reinsurance of Short-Duration and Long Duration Contracts – (December, 1992)**

Issued in December 1992, FAS No. 113 provided comprehensive guidance for accounting and reporting for reinsurance by cedants and reinsurers. This statement:

- Eliminates net accounting on the balance sheet (i.e. the practice of reporting assets and liabilities net of the effects of reinsurance). Because the legal obligations to policyholders have not been extinguished by reinsurance and because the cedant cannot offset obligations to policyholders with receivables from reinsurers, reinsurance receivables on unpaid claims and claims expenses and prepaid reinsurance premiums (ceded unearned premium reserves) are reported as assets.

- Establishes the conditions required for a contract with a reinsurer to be accounted for as reinsurance (Paragraph 9) as follows:
  9. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of short-duration contracts requires both of the following, unless the condition in paragraph 11 is met:
     a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.
     b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

- Made clear that the 9a. test requires that both the amount and timing of the reinsurer’s payments must depend on and vary directly with the amount and timing of the claims settled under the reinsured contracts. Contract features that delay timely reimbursement fail this test.

- Risk transfer is tested at the inception of the reinsurance contract. The risk transfer test is applied by discounting all cash flows between the cedant and reinsurer to present value under reasonably possible outcomes.

- Made clear that the significant loss in Paragraph 9b is evaluated in relation to the present value of amounts paid to the reinsurer. (In practice, accounting firms have implemented rules of thumb for reasonably possible and significant loss that have tended to increase more recently. One such
rule is the “10/10 rule” in which the reinsurer has a 10% or greater chance of incurring a 10% or greater present value loss under the contract).

- Defines prospective and retroactive reinsurance contracts and establishes separate accounting for each. A contract is determined to be prospective or retroactive depending on whether the contract reinsures future (prospective) or past (retrospective) loss events covered by the original insurance.
- Prescribes the accounting for reinsurance contracts by the cedant and reinsurer.
  1. Reinsurance accounting is appropriate only for prospective contracts that meet the paragraph 9a. and 9b. risk transfer tests and for those contracts that meet the conditions of paragraph 11 of FAS No. 113).
  2. Reinsurance accounting is not permitted, and deposit accounting is required for prospective or retroactive contracts that do not meet the paragraph 9a. and 9b. tests. Deposit accounting was not specifically defined in FAS No. 113, but specific guidance was contained in AICPA SOP 98-7.
  3. Prescribes retroactive reinsurance accounting for retroactive contracts. A gain from a retroactive reinsurance contract is required to be deferred from income and amortized over the estimated settlement period of the liabilities reinsured.
- Prohibits the immediate recognition of gains unless the cedant’s liability to the policyholders is extinguished.
- Requires that prospective and retroactive provisions within a single contract be accounted for separately where possible. If separate accounting for prospective and retroactive portions of a single contract is not possible, the entire contract must be accounted for as a retroactive contract.
- Provides comprehensive disclosure requirements for cedants and reinsurers.
**Valuation of Claim Liabilities Must Be at the Expected Level**

Valuation of claim liabilities; Paragraph 22 of GASB No. 10 states ... The liability should be based on the estimated ultimate cost of settling the claims... For purposes of selecting a claim valuation you would use the “expected level” as estimated by your actuary. The expected level is the best estimate on average of the ultimate loss settlement based on past loss payment patterns and expected future patterns.

**Can You Record Additional Liability Above Expected?**

No, not as a component of liabilities. You cannot create assets or liabilities in this way.

If you want to record a provision above expected the proper place is to segregate it as a designated component of net position (designated for catastrophic losses or for risk margin). However, this designation may not be recorded on the face of the financial statements but may be disclosed in the notes of the financial statements.

**Discounting Claims is not Mandated or Prohibited**

GASB 10 paragraph 24; The practice of presenting claims liabilities at the discounted present value of estimated future cash payments (discounted) is neither mandated nor prohibited....

**A Liability for Unallocated Loss Adjustment Expenses Must be Recorded**

Liabilities for claim adjustment expenses are broken down into two categories:

Allocated claim adjustment expenses are those that can be associated directly with specific claims paid or in the process of settling specific claims.

Unallocated claim adjustment expenses cannot be associated with specific claims but are related to claims paid or the process of settlement, such as salaries and other internal costs of the pool’s claims department.

(GASB 10 paragraph 23)
Premium Recognition; Only Record as Revenue the Earned Portion

Premiums or required contributions should be recognized as revenue over the contract period in proportion to the risk protection provided. (unearned premiums should be reported as a liability). GASB 10 paragraph 19

Equity Reporting:

Governmental insurance pools are enterprise fund types and as such equity should be titled net position or a similar designation but not fund balance which is a title used under governmental fund accounting.

Special segregation of retained earnings to provide for catastrophic losses or plans made by the board should be labeled “designated.” This may be important for internal accounting and reporting but the “restricted” title should not be used because it is for legal or contractual restrictions. It is recommended that such designations be reported in the notes to the financial statements and not on the face of the financial statements once you implement GASB 34.

In accordance with GASB 63 there are three categories of Net Position.

1. **Net Investment in Capital Assets Component of Net Position**
   This component consists of capital assets, net of accumulated depreciation, reduced by outstanding balances of debt related to these assets. Deferred outflows of resources and deferred inflows of resources that are related to the capital assets. These funds are separated because this net investment in capital assets is generally considered not spendable and a user should use this information in evaluating the net position available.

2. **Restricted Component of Net Position**
   This consists of restricted assets (those assets that are limited through regulation or contract to be applied or used for certain or limited purposes) reduced by liabilities and deferred inflows of resources related to these assets.

3. **Unrestricted Component of Net Position**
   These are the remaining net position not included in the two categories above.

GASB Does Not Allow Reporting of Proportionate Equity in an Insurance Pool

Recording the proportionate equity and further describing the limitations in the foot notes would be considered not adhering to accounting standards.
Paragraph 3. An entity should not consider its capitalization contributions to, or participation in, a public entity risk pool (with or without transfer or pooling of risk) to be an equity interest in a joint venture as defined in Statement 14.

Paragraph 26 ...The intent of Statement 14, paragraph 79, is that the joint venture provisions of Statement 14 do not apply to entities participating in a public entity risk pool...

Paragraph 36 ...the nature of a risk-sharing pool is such that its net income or loss does not accrue to participating entities except through formal mechanisms such as premium adjustments, dividends, and assessments that are specified in the pooling agreements.

Paragraph 74 of Statement 10 provides that entities that participate in risk-sharing pools under retrospectively rated policies or contracts should “accrue additional premiums or refunds on the basis of the group’s experience to date...” However, the recognition of these refunds is not equivalent of an equity interest and should not be construed as such.

Paragraph 70 of Statement 10, ... If it appears that the pool will not be able to meet its obligations and it is probable that the entity will be required to pay its own obligations if the pool fails, the amount of those obligations should be reported as an expenditure/expense and as a liability if they can be reasonably estimated....

Basically, if the pool you participate in has a going concern you report your proportional share of the net liabilities on the member statements. However the following conditions must be met:

1. The public entity risk pool appears that it will not be able to pay claims and related liabilities as they come due.

2. It is probable that the governmental entity will be required to pay its own claims.

3. A reasonable estimate of the amount of claims that will be paid by the governmental entity can be made.

Capitalization Contributions Made to Public Entity Risk Pools with Transfer or Pooling of Risk

Paragraph 4  A capitalization contribution to a public entity risk pool with transfer or pooling of risk should be reported as a deposit if it is probable that the contribution will
be returned to the entity upon either the dissolution of or the approved withdrawal from the pool. An entity’s determination that a return of the contribution is probable should be based on the provisions of the pooling agreement and an evaluation of the pool’s financial capacity to return the contribution. In governmental funds the balance should be reserved to indicate that the deposit is not appropriable for expenditure.

**Required Disclosures for Insurance Pools**

Under GASB 10 and related Revisions under GASB 30 an insurance pool is required to disclose the following:

GASB 10; Paragraph 49

- A description of the risk transfer or pooling agreement, including the rights responsibilities of the pool and the pool participants. Also provide a brief description of the number and types of entities participating in the pool.
- The basis for estimating the liabilities for unpaid claims and claim adjustment expenses. State that the liabilities are based on the estimated ultimate cost of settling the claims, including the effects of inflation and other societal and economic factors.
- The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period.
- The face amount and carrying amount of liabilities for unpaid claims and claim adjustment expenses that are presented at present value in the financial statements and the range of annual interest rates used to discount those liabilities.
- Whether the pool considers anticipated investment income in determining if a premium deficiency exists.
- The nature and significance of excess insurance or reinsurance transactions to the pool’s operations, including reinsurance premiums ceded, and estimated amounts that are recoverable from reinsurers and that reduce the liabilities as of the balance sheet date for unpaid claims and claim adjustment expenses.

**Reconciliation of Claims Liabilities by Type of Contract**

A reconciliation of total claims liabilities, including analysis of changes in aggregate liabilities for claims and claims adjustment expenses for the current fiscal year and the prior fiscal year, in this tabular format:

- Amount of liabilities for unpaid claims and claims adjustment expenses at the beginning of each fiscal year.
- Incurred claims and claim adjustment expenses:
  - Provision for insured events of prior fiscal years.
  - Increase (decrease) in the provision for insured events of prior fiscal years.
years.
  - Payments:
    - Claims and claim adjustment expenses attributable to insured events of the current fiscal year.
    - Claims and claim adjustment expenses attributable to insured events of prior fiscal years.
    - Other (Provide an explanation for each material item.)
  - Amount of liabilities for unpaid claims and claim adjustment expenses at the end of each fiscal year.

The schedule described above should be in total in the footnotes and a reconciliation by type of contract should be presented in the supplemental information section of the report.

Under GASB 10, you must report the aggregate outstanding amount of liabilities for which annuity contracts have been purchased from third parties in the claimants’ names and the related liabilities have been removed from the balance sheet.

Finally, disclosures require you to prepare a Ten-Year Claims Development Information schedule; (needs to conform with GASB 10)