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Governmental Accounting Standards Series

Statement No. 10 of the Governmental Accounting Standards Board

Accounting and Financial Reporting for Risk Financing and Related Insurance Issues

GASB

Governmental Accounting Standards Board
of the Financial Accounting Foundation

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Summary

This Statement establishes accounting and financial reporting standards for risk financing and insurance-related activities of state and local governmental entities, including public entity risk pools. The risks of loss that are included within the scope of this Statement include torts; theft of, damage to, or destruction of assets; business interruption; errors or omissions; job-related illnesses or injuries to employees; acts of God; and any other risks of loss assumed under a policy or participation contract issued by a public entity risk pool. Also included are risks of loss resulting when an entity agrees to provide accident and health, dental, and other medical benefits to its employees.

This Statement generally requires public entity risk pools to follow the current accounting and financial reporting standards for similar business enterprises, based primarily on FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.* Pool premiums or required contributions are required to be recognized as revenue over the contract period in proportion to the amount of risk protection provided. Claims costs, including claim adjustment expenses and estimates of costs for claims relating to covered events that have occurred but have not been reported to the pool, should be recognized in the period in which the event that triggers coverage under the policy or participation contract occurs. Costs that vary with and are primarily related to the acquisition of insurance or pool participation contracts (acquisition costs) should be capitalized and charged to expense in proportion to premium revenue recognized. This Statement also requires disclosure of certain ten-year revenue and claims development data as required supplementary information.

State and local governmental entities other than public entity risk pools are required to report an estimated loss from a claim as an expenditure/expense and as a liability if both of these conditions are met:

a. Information available before the financial statements are issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will also occur, confirming the fact of the loss.
b. The amount of the loss can be reasonably estimated.

If a governmental entity other than a pool uses a single fund to account for its risk financing activities, that fund should be either the general fund or an internal service fund. Both funds must use the method described above for calculating claims liabilities. However, if an internal service fund is used, the entity also may use an actuarial method,

including a provision for future catastrophe losses, to calculate the amount that the internal service fund charges other funds of the entity. Charges made on that basis should be reported as revenue in the internal service fund and as expenditures/expenses in the other funds of the entity. Charges in excess of those amounts should be reported as operating transfers. Any surplus fund balance in an internal service fund resulting from use of a provision for catastrophe losses is required to be reported as a designation of equity for future catastrophe losses. If the general fund is used, the entity may use any method it chooses to allocate loss expenditures/expenses to the other funds of the entity.

This Statement is consistent with proposed provisions of the GASB's August 14, 1989 revised Exposure Draft, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements* (MFBA ED), which would require governmental funds to report expenditures when incurred, regardless of when paid. The MFBA ED proposes standards *only* for governmental fund *operating statements*, not their balance sheets. The Board will resolve issues about the balance sheet effect of liabilities arising from these expenditure accruals in its financial reporting project. Accordingly, this Statement does not provide guidance on the display of claims liabilities reported *by governmental funds.*

The requirements of this Statement that affect public entity risk pools are effective for financial statements for periods beginning after June 15, 1990. The requirements for entities other than pools are effective on the same date that the Board's final Statement on measurement focus and basis of accounting for governmental funds is effective. The transition date tentatively established by the MFBA ED is for financial statements for periods beginning after June 15, 1993. However, earlier application is permitted. Entities other than pools that use an internal service fund to report their risk management activities should report all claims liabilities in that fund and report the transfer of liabilities previously reported in the general long-term debt account group as an adjustment of internal service fund beginning retained earnings.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including public benefit corporations and authorities, public employee retirement systems, and governmental utilities, hospitals, colleges, and universities. Paragraph 16 discusses the applicability of this Statement.

Statement No. 10 of the
Governmental Accounting
Standards Board

Accounting and Financial Reporting for Risk Financing and Related Insurance Issues

November 1989

Governmental Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

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November 1989

CONTENTS

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INTRODUCTION AND BACKGROUND INFORMATION

Scope of This Statement

1. This Statement establishes accounting and financial reporting standards for **risk**[1] financing and **insurance**-related activities of state and local governmental entities, including **public entity risk pools**. Risks of loss from the following kinds of events are included within the scope of this Statement:

a. **Torts**.
b. Theft of, damage to, or destruction of assets.
c. Business interruption.
d. Errors or omissions.
e. Job-related illnesses or injuries to employees.
f. **Acts of God**.
g. Other risks of loss of participating entities assumed under a **policy** or **participation contract**[2] issued by a public entity risk pool.

2. This Statement also applies to losses resulting when an entity agrees to provide accident and health, dental, and other medical benefits to its employees and retirees, and their dependents and beneficiaries, based on covered events that have already occurred. However, the scope of this Statement *excludes* all postemployment benefits that governmental employers expect to provide to current and future retirees, their beneficiaries, and their dependents in accordance with the employer's agreement to provide those future benefits. Those benefits are currently the subject of a separate GASB project. Also excluded from the scope of this Statement are Medicaid insurance plans provided to low-income state residents under Title XIX of the Federal Social Security Act.

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[1]Terms defined in Appendix B, "Glossary," are printed in **boldface type** the first time they are used.

[2]The Board is aware that some public entity risk pools are prohibited by state statute from providing *insurance* coverage to their participants. In these cases, using the terms *premiums, policies*, and *dividends* to describe the transactions of these pools is inaccurate. However, those terms are used in this Statement because they are universally understood and make the Statement easier to use. Alternative terms—in this case, *participation contract* instead of *policy*—are presented the first time the term is used and in other situations in which it is confusing not to use both terms. The Board in no way intends that insurance terms must be used to describe the transactions of individual pools in their financial reports.

3. The recognition and measurement of liabilities that arise from breach of contract[3] or similar actions, such as claims for delays or inadequate specifications on contracts or for guarantees of the indebtedness of others, property tax appeals, and unemployment compensation claims, are set forth in NCGA Statement 4, *Accounting and Financial Reporting for Claims and Judgments and Compensated Absences.* The requirements of that NCGA Statement are contained in Section C50, "Claims and Judgments," of the June 15, 1987 GASB *Codification of Governmental Accounting and Financial Reporting Standards* (Codification).

Background

4. GASB Concepts Statement No. 1, *Objectives of Financial Reporting,* identifies three groups of primary users of external state and local governmental financial reports: (a) citizens and citizen groups, (b) legislative and oversight bodies, and (c) investors and creditors.

5. For public entity risk pools, the Board has more specifically identified those groups it believes are the primary users of external public entity risk pool financial reports:

a. Pool participants and those considering pool participation.
b. Legislative and oversight bodies (such as state regulatory bodies).
c. **Reinsurers** and **excess insurers**.
d. Investors and creditors.

6. **Risk management** is the process of managing an organization's activities to minimize the adverse effects of certain types of losses. The main elements of risk management are risk control (to minimize the losses that strike an organization) and risk financing (to obtain finances to provide for or restore the economic damages of those losses). Risk financing techniques include risk retention (sometimes referred to as **self-insurance)**, risk transfer to and from[4] an insurer (either a commercial insurance company or a public entity risk pool), and risk transfer to a noninsurer.

[3]However, liability for the tort of another assumed by contract by a governmental entity or a public entity risk pool on behalf of a participating entity *is* included within the scope of this Statement. For example, a local government may agree *by contract* to assume the liability for another jurisdiction's police officers in exchange for police services provided by that jurisdiction and not otherwise available to the governmental entity.

[4]An entity may, in effect, transfer risk *from* a public entity risk pool when it agrees to assume some of the losses of other public entities via a risk-sharing agreement with pool participants.

Transfer of Risk

7. One question that surfaces repeatedly in any discussion of insurance and risk management activities is whether risk has, in fact, been transferred or whether it has been retained by the governmental entity, even if a third party (such as a commercial insurer) is involved. The important concept here is that risk retention and risk transfer generally are not mutually exclusive or absolute. For example, assume an entity other than a pool pays a **premium** or **required contribution** of some sort to an insurer or pool, with the ultimate charge to the entity being determined based on the individual entity's **claims**/loss experience. If that entity's losses exceed the initial charge, it will be assessed an additional amount to fully reimburse the insurer for those losses. On the other hand, if the premium exceeds the losses, the entity will receive a refund. In this situation, risk has been retained, the annual premium is more in the nature of a **deposit**, and the insurer is functioning more as a claims servicer.

8. As another example, assume an insurer collects premiums that it estimates will cover the costs of *all* claims for which the insurer is obligated. If an entity's losses exceed its premiums, there is no individual supplemental assessment; on the other hand, if the entity's losses are low, it will not receive a refund. The insurer views its activities in the aggregate, rather than on an individual insured entity basis (as in paragraph 7). It may make an *overall* supplemental assessment or declare a refund depending on the loss experience of all the entities it insures. Or it may increase or decrease premiums for the same type of coverage in the following years. The insurer, in effect, pools risks among insured entities. Except for deductible amounts, in this example, risk appears to have been transferred.

9. However, also important is the concept that a transfer of risk is only as good as the amount of assets the insurer has available to pay claims on the entity's behalf. For example, if legislation establishing a multigovernment pool prohibits it from making supplemental assessments but that pool has no source of assets to pay the entity's claims, the entity remains liable for those unpaid claims and transfer of risk has not occurred *for those claims*.

Public Entity Risk Pools

10. This Statement defines *public entity risk pool* as a cooperative group of governmental entities joining together to finance an exposure, liability, or risk. Risk may include **property and liability**, workers' compensation, or employee health care. A pool may be a stand-alone entity or be included as part of a larger governmental entity that acts as the pool's sponsor.

11. A governmental entity that is a pool's sponsor may also participate in the pool for its own risk management function. For example, a state may host, but not participate in, a risk management pool that provides workers' compensation protection for all local school districts within the state. Or a state may already pool its general liability risks *internally* and decide to extend that pooling to local governments that are unable to obtain private insurance coverage within that state. Entities participating in the state's pool may share risks with other participants, including the state. A state insurance purchasing pool may simply act as a purchaser of private insurance to obtain economies of scale for itself and the local governments that elect to join in this joint purchasing arrangement.

12. Stand-alone pools are established under authorizing statute by agreement of any number of state and local governmental entities. Stand-alone pools are sometimes organized or sponsored by municipal leagues, school associations, or other types of associations of governmental entities. A stand-alone pool is frequently operated by a board that has as its membership one member from each participating government. It typically has no publicly elected officials or power to tax.

13. There are four basic types of public entity risk pools. They are:

a. A *risk-sharing* pool—an arrangement by which governments pool risks and funds and share in the cost of losses.
b. An *insurance-purchasing* pool—an arrangement by which governments pool funds or resources to purchase commercial insurance products. This arrangement is also called a *risk-purchasing group.*
c. A *banking* pool—an arrangement by which monies are made available for pool members in the event of loss on a loan basis.
d. A *claims-servicing* or *account* pool—an arrangement by which a pool manages separate accounts for each pool member from which the losses of that member are paid.

Of course, a pool could serve only one or several of these functions. Pools that act *only* as banking or claims-servicing pools do not represent transfer of risk.

Related GASB Projects

14. On August 14, 1989, the Board issued a revised Exposure Draft of a proposed Statement, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements* (MFBA ED). The MFBA ED proposes that governmental fund operating statements use a flow of financial resources measurement focus and an accrual basis of accounting to measure the extent to which financial resources obtained during a period are sufficient to cover claims incurred during that period against financial resources. The Board will resolve issues about the balance sheet effect of liabilities arising from these expenditure accruals, including those resulting from risk management and related insurance transactions, *in its financial reporting project.* Those issues include which long-term liabilities should affect fund balance and how long-term liabilities should be displayed. Therefore, this Statement provides recognition and measurement guidance for claims and judgments and related insurance transactions within the context of the flow of financial resources measurement focus but does not provide guidance on whether those long-term liabilities should affect fund balance or how those long-term liabilities should be displayed.

15. Because the recognition of claims expenditures/expenses is linked to the measurement focus proposed in the MFBA ED, the effective date of this Statement *for entities other than pools* is also linked to the project. (See paragraph 82.) The effective date currently proposed is for financial statements for periods beginning after June 15, 1993. However, early application of this Statement is permitted. Current generally accepted accounting principles—as set forth in Codification Section C50—continue to apply to all state and local governmental entities. That section requires entities to recognize loss liabilities and related expenditures/expenses in conformity with FASB Statement No. 5, *Accounting for Contingencies*, subject to the use of the modified accrual basis of accounting for governmental funds and expendable trust funds.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Applicability of This Statement

16. The requirements of paragraphs 17 through 51 and paragraph 81 of this Statement apply to all public entity risk pools. The requirements of paragraphs 52 through 80 and paragraphs 82 and 83 apply to all state and local governmental entities, including public benefit corporations and authorities, public employee retirement systems, and governmental utilities, hospitals, colleges, and universities. This Statement supersedes portions of the Codification as outlined in Appendix E.

Public Entity Risk Pools

17. Public entity risk pools in which there is some transfer or pooling (sharing) of risk should follow the accounting and reporting requirements set forth in paragraphs 18 through 50. Paragraphs 18 and 51 provide guidance for pools not involving transfer or pooling of risk.

Fund Type to Use

18. All public entity risk pools should account for their activities in an enterprise fund regardless of whether there is a transfer or pooling (sharing) of risk.

Premium Revenue Recognition

19. Premiums or required contributions ordinarily should be recognized as revenue over the contract period in proportion to the amount of risk protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums should be recognized as revenue over the period of risk in proportion to the amount of risk 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 risk protection changes according to a predetermined schedule.

20. If premiums are subject to adjustment (for example, **retrospectively rated** or other experience-rated contracts for which the premium is determined after the contract period based on claims experience, or **reporting-form contracts** for which the premium is

adjusted after the contract period based on the value of insured property), premium revenue should be recognized as follows:

a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the contract period. The estimated ultimate premium should be revised to reflect current experience.
b. If the ultimate premium cannot be reasonably estimated, the **cost recovery method** or the **deposit method** should be used until the ultimate premium becomes reasonably estimable.

21. If a portion of the premium is specifically identified as being collected for *future* **catastrophe** losses, that amount should be recognized as revenue over the contract period. In addition, that amount should be separately identified as a reservation of pool equity if it is contractually restricted for that specific future use or if it is legally restricted for that specific use by an organization or individual *outside the entity*.

Claim Cost Recognition

22. A **liability for unpaid claims costs**, including estimates of costs relating to **incurred but not reported (IBNR) claims**,[5] should be accrued when insured events occur or, for **claims-made policies**, in the period in which the event that triggers coverage under the policy or participation contract occurs. That liability should be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. 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. Changes in estimates of claims costs resulting from the continuous review process and differences between estimates and payments for claims should be recognized in results of operations of the period in which the estimates are changed or payments are made. Estimated recoveries on unsettled claims, such as **salvage** or **subrogation**, should be evaluated in terms of their estimated realizable value and deducted from the liability for

[5]IBNR includes (a) known loss events 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. IBNR, therefore, is largely an estimate of loss and claim adjustment expenses associated with future likely claims activity based on historical actual results that establish a reliable pattern. For example, after reviewing historical claims experience, one might find that only 40 percent of all claims are normally reported during the year of occurrence, an additional 50 percent the next year, and the remainder in the third year. This pattern would be used to estimate IBNR amounts and the timing of those amounts for financial reporting purposes.

unpaid claims. Estimated recoveries on settled claims also should be deducted from the liability for unpaid claims.

23. **Liabilities for claim adjustment expenses** should be accrued when the related liability for unpaid claims is accrued. **Claim adjustment expenses** include all costs expected to be incurred in connection with the settlement of unpaid claims. *Allocated* claim adjustment expenses are those that can be associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Claim adjustment expenses also include *unallocated* 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.

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 contractual obligations to pay specific amounts on fixed or determinable dates.

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.

26. If a pool purchases an **annuity contract** in the claimant's name to satisfy a claim liability and the likelihood that the pool will be required to make future payments on the claim is **remote**, the pool is considered to have satisfied its primary liability to the claimant. Accordingly, the annuity contract should not be reported in, and the related liability should be removed from, the pool's balance sheet. However, the aggregate outstanding amount of liabilities removed from the pool's financial statements should be disclosed as long as those contingent liabilities are outstanding. If it is later determined that the primary liability will revert back to the pool, the liability should be reinstated on the pool's balance sheet. (Annuity contracts used to settle claims for which the claimant has signed an agreement releasing the entity from further obligation and for which the likelihood that the pool will be required to make future payments on those claims is remote should not be included in this disclosure.)

Disclosure of Loss Contingencies

27. If no accrual is made for an insured event because either a loss is not probable or the amount of the loss cannot be estimated (for example, on a case-by-case review of losses), or if an exposure to loss exists in excess of the amount accrued in accordance with the provisions of paragraph 22 (for example, on an actuarial projection of losses), disclosure of the contingency should be made if there is at least a **reasonable possibility** that a loss or an additional loss may have been incurred. The disclosure should indicate the nature of the contingency and should give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unreported claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

Acquisition Costs

28. Policy or participation contract **acquisition costs** are those costs that vary with and are primarily related to the acquisition of new and renewal contracts. Commissions and other costs (for example, salaries of certain employees involved in the **underwriting** and policy issue functions, and inspection fees) that are primarily related to contracts issued or renewed during the period in which the costs are incurred should be considered acquisition costs.

29. Acquisition costs should be capitalized and charged to expense in proportion to premium revenue recognized. To associate acquisition costs with related premium revenue, these costs should be allocated by groupings of **types of contracts** consistent with the pool’s manner of acquiring, servicing, and measuring the revenue and expense elements of its contracts. Unamortized acquisition costs should be classified as an asset.

30. If acquisition costs are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once determined, should be applied to applicable unearned premiums throughout the contract periods.

Other Costs

31. Costs incurred during the period other than those relating to claims, such as those relating to investment management, general administration, and policy **maintenance**, that do not vary with and are not primarily related to the acquisition of new and renewal contracts should be charged to expense as incurred.

Policyholder Dividends

32. A **policyholder 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. Policyholder dividends include amounts returned to pool participants from excess premiums for future catastrophe losses (paragraph 21).

Experience Refunds

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.

Premium Deficiency

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.

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.[6]

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 collectibility is probable and reasonably estimable. (Appendix C provides examples of premium deficiency calculations.)

Reinsurance

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 the 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.

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. (See paragraph 29.) 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.

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 for as a deposit by the pool. Those contracts may be structured in various ways, but if,

[6]Pools are required to disclose whether anticipated investment income is considered in determining if a premium deficiency exists. (See paragraph 49e.)

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.

Investments

40. Bonds should be reported at amortized cost if the pool has both the ability and the intent to hold the bonds until maturity and there is no decline in the market value of the bonds other than a temporary decline. If a pool is a trader in bonds and does not intend to hold the bonds until maturity, bonds should be reported at market, and temporary changes in the market value of the bonds should be recognized as unrealized gains or losses. (See paragraph 46.)

41. Common and nonredeemable preferred stocks should be reported at market, and temporary changes in the market value of those securities should be recognized as unrealized gains or losses. (See paragraph 46.) Preferred stocks that by their provisions must be redeemed by the issuer should be reported at amortized cost if the pool has both the ability and the intent to hold the stocks until redemption and there is no decline in the market value of the stocks other than a temporary decline. If the pool does not have the ability or intent to hold those stocks to maturity, preferred stocks should be reported like investments in common and nonredeemable preferred stocks.

42. Mortgage loans should be reported at outstanding principal balances if acquired at par value, or at amortized cost if purchased at a discount or premium, with an allowance for estimated uncollectible amounts, if any. Amortization and other related charges or credits should be charged or credited to investment income. Changes in the allowance for estimated uncollectible amounts relating to mortgage loans should be included in realized gains and losses.

43. Real estate investments should be reported at cost less (a) accumulated depreciation and (b) an allowance for any impairment in value. Depreciation and other related charges or credits should be charged or credited to investment income. Changes in the allowance for any impairment in value relating to real estate investments should be included in realized gains and losses.

44. All other investments should be reported at cost plus or minus any unamortized premium or discount. However, if the market value of such investments declines below

its carrying amount and it is probable a loss will be realized in the future (for example, because the pool expects to sell the investment to meet its cash flow needs), an estimated loss should be reported as a realized loss in the pool's operating statement and as a reduction of the carrying amount of the investment.

45. Loan origination and commitment fees and direct loan origination costs should be accounted for as prescribed in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which establishes the accounting for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or group of loans. The provisions of that Statement apply to all types of loans (including debt securities); they also specify the accounting for fees and initial direct costs associated with leasing. FASB Statement 91 requires the following:

a. Loan origination fees should be recognized over the life of the related loan as an adjustment of yield.
b. Certain direct loan origination costs should be recognized over the life of the related loan as a reduction of the loan's yield.
c. All loan commitment fees should be deferred except for certain retrospectively determined fees. Commitment fees meeting specified criteria should be recognized over the loan commitment period; all other commitment fees should be recognized as an adjustment of yield over the related loan's life or, if the commitment expires unexercised, recognized in income on expiration of the commitment.
d. Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans should be recognized as an adjustment of yield generally by the interest method based on the contractual terms of the loan; however, prepayments may be anticipated in certain specified circumstances.

46. Realized gains and losses on all investments (except those that are accounted for as foreign currency or futures contracts hedges)[7] should be recognized in the operating statement as a component of other income. In addition, the amount of those gains and losses should be separately disclosed either by presenting it as a separate item in the operating statement or disclosing it in the notes to financial statements. Realized gains and losses should not be deferred, either directly or indirectly. Unrealized investment gains and losses should be reported as a separate component of equity. Except as discussed in paragraph 47, unrealized gains or losses on common stocks, preferred stocks,

[7]FASB Statements No. 52, *Foreign Currency Translation*, and No. 80, *Accounting for Futures Contracts*, provide the accounting and reporting requirements for these hedges.

or publicly traded bonds[8] should not be recognized in income until the sale, maturity, or other disposition of the investment.

47. If a decline in the value of a common stock, preferred stock, publicly traded bond, or other investment below its cost or amortized cost is considered to be other than temporary, the investment should be reduced to its net realizable value, which becomes the new cost basis. The amount of the reduction should be reported as a realized loss. A recovery from the new cost basis should be recognized as a realized gain only at the sale, maturity, or other disposition of the investment.

Real Estate Used in the Pool's Operations

48. Real estate should be classified either as an investment or as real estate used in the pool's operations, depending on its predominant use. Depreciation and other real estate operating costs should be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rental expense should not be recognized for real estate used in the pool's operations.

Disclosures

49. Public entity risk pools should make these disclosures:

a. A description of the risk transfer or pooling agreement, including the rights and responsibilities of the pool and the pool participants. Also provide a brief description of the number and types of entities participating in the pool.
b. 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.
c. The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period.
d. 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.
e. Whether the pool considers anticipated investment income in determining if a premium deficiency exists.
f. The nature and significance of excess insurance or reinsurance transactions to the pool's operations, including reinsurance premiums ceded, and estimated amounts that

[8]This paragraph is not intended to preclude the accrual of losses on private-placement bonds when both conditions of paragraph 53 are met.

are recoverable from reinsurers and that reduce the liabilities as of the balance sheet date for unpaid claims and claim adjustment expenses.

g. A reconciliation of total claims liabilities, including an analysis of changes in aggregate liabilities for claims and claim adjustment expenses for the current fiscal year and the prior fiscal year, in this tabular format:
    (1) Amount of liabilities for unpaid claims and claim adjustment expenses at the beginning of each fiscal year.
    (2) Incurred claims and claim adjustment expenses:
        (a) Provision for insured events of the current fiscal year.
        (b) Increase (decrease) in the provision for insured events of prior fiscal years.
    (3) Payments:
        (a) Claims and claim adjustment expenses attributable to insured events of the current fiscal year.
        (b) Claims and claim adjustment expenses attributable to insured events of prior fiscal years.
    (4) Other. (Provide an explanation of each material item.)
    (5) Amount of liabilities for unpaid claims and claim adjustment expenses at the end of each fiscal year.

h. 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. (Annuity contracts used to settle claims for which the claimant has signed an agreement releasing the entity from further obligation and for which the likelihood that the pool will be required to make future payments on those claims is remote should not be included in this disclosure.)

Required Supplementary Information

50. The following revenue and claims development information should be included as required supplementary information[9] immediately after the notes to financial statements in pool separate financial reports. (This disclosure is illustrated in Appendix D.) (Pools that are included as part of a combined general government reporting entity and that do not issue separate financial reports should present the information as statistical information in the combined entity's comprehensive annual financial report.)

a. A table that presents the following information:
    (1) Amounts of reported premium or required contribution revenue (net of excess or reinsurance) and reported investment revenue for each of the past ten fiscal years including the latest fiscal year.

[9]Required supplementary information consists of statements, schedules, statistical data, or other information that the Board has determined is necessary to supplement, although not required to be a part of, the general purpose financial statements (GPFS).

(2) Amounts of reported unallocated claim adjustment expenses (see paragraph 23) and reported other costs (see paragraph 31) for each of the past ten fiscal years including the latest fiscal year.

(3) Total amount of incurred claims and allocated claim adjustment expenses (both paid and accrued and net of loss assumed by excess or reinsurers) as originally reported at the end of each of the past ten policy years including the latest policy year. Amounts should be limited to provisions for claims resulting from events that triggered coverage under the policy or participation contract in that year **(policy-year basis).**

(4) The cumulative amount paid as of the end of the policy year and each succeeding year for each of the incurred claims and allocated expense amounts presented in (3) above.

(5) The reestimated amounts for incurred claims and claim adjustment expenses as of the end of each succeeding year for each of the policy years presented in (3) above.

(6) The change in incurred claims and claim adjustment expenses from the original estimate, based on the difference between the latest reestimated amount presented in (5) above for each of the policy years and the originally established incurred claims and claim adjustment amounts reported in (3).

b. In addition to the reconciliation of total claims liabilities (paragraph 49g), a reconciliation of claims liabilities by **type of contract,** including an analysis of changes in liabilities for claims and claim adjustment expenses for the current fiscal year and the prior year, in the same tabular format required by paragraph 49g.

During the transition period when ten years of information about claims liabilities and claim adjustment expenses may not be available, all information required by item a above should be presented only for as many years as that information is available. If changes in a pool’s loss, expense, reinsurance, excess insurance, or other transactions materially affect pool revenues, expenses, or liabilities in a manner not fairly disclosed or presented in the tables above, the pool should expand these disclosures to show additional detail (such as gross, ceded, and net revenues and liabilities or separate information for each type of contract) to keep the schedules from being misleading or to keep trends from becoming obscured.

Pools Not Involving Transfer or Pooling of Risk

51. Some public entity risk pools do not involve any transfer or pooling of risk among pool participants. Each participant is completely responsible for (and only responsible for) its own claims liabilities. In this type of arrangement, the pool is acting as a claims servicer, not as an insurer. Accordingly, the provisions of paragraphs 19 through 50 do not apply. Instead, the operating statement of this type of pool should report claims-servicing revenue and administrative costs. Amounts collected or due from pool participants and paid or to be paid to settle claims should be reported as a net asset or liability on an accrual basis, as appropriate.

Entities Other Than Pools—General Principles

52. State and local governments manage and finance risks in any number of ways ranging from purchasing commercial insurance for all risks of loss, to participating in public entity risk pools, to retaining all risks of loss. State and local governments may participate in a variety of public entity risk pools. Paragraph 13 discusses four basic types of pools. Paragraphs 53 through 62 provide general principles for recognition and disclosure of claims liabilities and expenditures/expenses and related transactions. Accounting for participation in pools depends on whether the entity transfers risk to the pool or pools risks with other pool participants, or whether the pool simply performs a claims-servicing function for the entity. Paragraphs 69 and 70 provide guidance on accounting when an entity other than a pool participates in a pool and transfers or pools risk. Paragraph 71 provides guidance when an entity participates in a pool without transfering or pooling risk. Paragraph 63 provides that if an entity uses a single fund to account for its risk financing activities, that fund should be either the general fund or an internal service fund. The accounting in both funds is discussed in paragraphs 64 through 68.

Liability and Expenditure/Expense Recognition and Measurement

53. Except as provided in paragraph 66 when an internal service fund is used, if risk of loss or a portion of risk of loss from the events listed in paragraphs 1 and 2 has not been transferred to an unrelated third party, state and local governmental entities should report an estimated loss from a claim as an expenditure/expense and as a liability if *both* of these conditions are met:

a. Information available before the financial statements are issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.[10] It is implicit in this condition that it must be probable that one or more future events will also occur confirming the fact of the loss.
b. The amount of loss can be reasonably estimated.

This Statement is not intended to inhibit or restrict the method of allocation of those expenditures/expenses and liabilities among funds.

54. When condition 53a is met for a particular loss contingency (or group of loss contingencies) and the reasonable estimate of the loss is a range, condition 53b is met and an amount should be accrued for the loss. When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount should be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range should be accrued. Even though the minimum amount in the range is not necessarily the amount of loss that ultimately will be determined, it is not likely that the ultimate loss will be less than the minimum amount.

55. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable, reasonably possible,* and *remote* to identify three areas within that range, as follows:

a. *Probable*. The future event or events are likely to occur.
b. *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
c. *Remote.* The chance of the future event or events occurring is slight.

56. As noted above, if a claim is asserted and the probable loss is reasonably estimable, the expenditure/expense and liability should be recognized in the financial statements. There are also situations in which incidents occur before the balance sheet date but claims are not reported or asserted when the financial statements are prepared. If an incurred but not reported (IBNR) loss can be reasonably estimated and it is probable that a claim will be asserted, the expenditure/expense and liability should be recognized. (See footnote 5.)

57. Claims liabilities, including IBNR, should be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic

[10]*Date of the financial statements* means the end of the most recent accounting period for which financial statements are being presented.

factors), using past experience adjusted for current trends, and any other factors that would modify past experience. Expenditures/expenses and liabilities may be estimated through a case-by-case review of all claims, the application of historical experience to the outstanding claims, or a combination of these methods. Estimates of IBNR losses should be based on historical experience. When historical experience is used, the outstanding claims should be stratified by amount *and* type of claim, and the strata should be sufficiently refined to assure that the estimation is reasonable.

Disclosure of Loss Contingencies

58. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 53 are not met, or if an exposure to loss exists in excess of the amount accrued in accordance with the provisions of paragraph 53, disclosure of the contingency should be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.[11] The disclosure should indicate the nature of the contingency and should give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unreported claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

Discounting

59. 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 contractual obligations to pay money on fixed or determinable dates.

60. If claims liabilities are discounted, the entity should use a rate that is determined by giving consideration to such factors as the entity's settlement rate for those liabilities and its investment yield rate.

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[11]For example, disclosure should be made of any loss contingency that meets the condition in paragraph 53a but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 53b). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 53a, namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements.

Annuity Contracts

61. If an entity purchases an annuity contract in the claimant's name to satisfy a claim liability and the likelihood that the entity will be required to make future payments on the claim is remote, the entity is considered to have satisfied its primary liability to the claimant. Accordingly, the annuity contract should not be reported in, and the related liability should be removed from, the entity's balance sheet. However, the aggregate outstanding amount of liabilities removed from the entity's financial statements should be disclosed as long as those contingent liabilities are outstanding. If it is later determined that the primary liability will revert back to the entity, the liability should be reinstated on the entity's balance sheet. (Annuity contracts used to settle claims for which the claimant has signed an agreement releasing the entity from further obligation and for which the likelihood that the entity will be required to make future payments on those claims is remote should not be included in this disclosure.)

Investments

62. Investments associated with an entity's risk financing activities that are maintained separately from other investments of the entity should nevertheless be valued in the same manner as all other investments reported in that fund type.

Fund Type to Use

63. If a single fund is used to account for an entity's risk financing activities, that fund should be either the general fund or an internal service fund.[12]

Risk Retention by Entities Other Than Pools

Use of the General Fund

64. If an entity uses the general fund to account for its risk financing activities, that fund should recognize claims liabilities and expenditures/expenses in accordance with paragraphs 53 through 57. Claims liabilities should be reduced by amounts expected to be

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[12]Participation in risk-financing internal service funds is not limited to governmental funds. Entities that are reported as proprietary funds or trust funds and that are component units of an oversight entity may participate in a risk-financing internal service fund of that oversight entity. However, entities that are reported as proprietary or trust funds and that are not considered to be a component unit of another governmental entity should not use an internal service fund (and the related provisions of paragraph 66) to report their own risk financing activities.

recovered through excess insurance. Claim amounts that are probable but not reasonably estimable should be disclosed in accordance with paragraph 58. That paragraph also requires disclosures about losses that are reasonably possible. The entity may use any method it chooses to allocate loss expenditures/expenses to the other funds of the entity. However, if the total amount charged to the other funds (including the general fund itself) exceeds total expenditures and liabilities determined in accordance with paragraphs 53 through 57, the excess amounts should be reported as operating transfers. Codification Section 1800, "Classification and Terminology," paragraph .103, provides that transactions that constitute reimbursements of a fund for expenditures/expenses initially made from it that are properly applicable to another fund should be reported as expenditures or expenses in the reimbursing fund and as reductions of the expenditure/expense in the fund that is reimbursed.

Use of an Internal Service Fund

65. If an entity uses an internal service fund to account for its risk financing activities, that fund should recognize claims expenses and liabilities in accordance with paragraphs 53 through 57. Claims expenses and liabilities should be reduced by amounts expected to be recovered through excess insurance. Claim amounts that are probable but not reasonably estimable should be disclosed in accordance with paragraph 58. That paragraph also requires disclosures about losses that are reasonably possible.

66. The internal service fund may use any basis it considers appropriate to charge other funds of the entity, as long as these conditions are met:

a. The total charge by the internal service fund to the other funds for the period is calculated in accordance with paragraphs 53 through 57, *or*
b. The total charge by the internal service fund to the other funds is based on an **actuarial method** or historical cost information and adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal.
c. In addition to item b above, the total charge by the internal service fund to the other funds may also include a reasonable provision for expected future catastrophe losses.

67. Charges made in accordance with the foregoing provisions should be recognized as revenue by the internal service fund and as expenditures/expenses by the other funds of the entity. Deficits, if any, in the internal service fund resulting from application of paragraph 66b and c do not need to be charged back to the other funds in any one year, as

long as adjustments are made over a reasonable period of time; however, a deficit fund balance of the internal service fund should be disclosed in the notes to financial statements. Retained earnings in the internal service fund resulting from application of paragraph 66c should be reported as equity designated for future catastrophe losses in the notes to the financial statements.

68. If the charge by the internal service fund to the other funds is greater than the amount resulting from the application of paragraph 66, the excess should be reported in both the internal service fund and the other funds as an operating transfer. If the charge by the internal service fund to the other funds fails to recover the full cost of claims over a reasonable period of time, any deficit fund balance in the internal service fund should be charged back to the other funds and reported as an expenditure/expense of those funds.

Entities Participating in Public Entity Risk Pools with Transfer or Pooling of Risk

69. If a governmental entity participates in a pool in which there is a transfer or pooling (sharing) of risks among the participants of that pool, the entity should report its premium or required contribution as insurance expenditure/expense. If the pooling agreement permits the pool to make additional assessments to its members, the entity should consider the likelihood of additional assessments and report an additional expenditure/expense and liability if an assessment is probable and can be reasonably estimated. (See paragraph 53.) Assessment amounts that are probable but not reasonably estimable should be disclosed in accordance with paragraph 58. That paragraph also requires disclosures about losses that are reasonably possible.

70. If the pooling agreement does not provide for additional member assessments and the pool reports a deficit for its operations, the pool member should consider the financial capacity or stability of the pool to meet its obligations when they are due. 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. The disclosure requirements of paragraph 58 apply to probable losses that are not reasonably estimable and losses that are reasonably possible.

Entities Participating in Public Entity Risk Pools without Transfer or Pooling of Risk

71. Sometimes an entity contracts with other entities to service its uninsured claims. If an entity participates in a pool in which there is no transfer of risk to the pool or pooling of risk with other pool participants, it should recognize and measure its claims liabilities and related expenditures/expenses in accordance with paragraphs 53 through 58 because risk of loss has not been transferred to an unrelated third party. Payments to the pool should be reported either as deposits or as reductions of the claim liability, as appropriate.

Entities Other Than Pools—Insurance-Related Transactions

Claims-Made Policies

72. A claims-made policy represents a transfer of risk within the policy limits to the insurer or pool for claims and incidents *reported to* the insurer or pool; however, this policy does not represent a transfer of risk for claims and incidents not reported to the insurer. Consequently, an entity that is insured under a claims-made policy should account for the estimated cost of those claims and incidents not reported to the insurer in accordance with paragraphs 53 through 58. This should be done unless the entity has bought **tail coverage** and included the cost of the premium or required contribution as an expenditure/expense in the financial statements for that period.

Retrospectively Rated Policies and Contracts

73. An entity with a retrospectively rated policy or contract whose ultimate premium or required contribution is based primarily on the entity's loss experience should account for the minimum premium as expenditure/expense over the period of coverage under the policy and accrue estimated losses from reported and unreported claims in excess of the minimum premium as indicated in paragraphs 53 through 57. However, such estimated losses should not be accrued in excess of a stipulated maximum premium or contribution requirement. If the entity cannot estimate losses from reported and unreported claims, as indicated in paragraphs 53 through 57, the entity should disclose the existing contingency in the notes to the financial statements. (See paragraph 58.)

74. An entity insured under a retrospectively rated policy or contract with premiums or required contributions based primarily on the experience of a group of entities should amortize the initial premium to expenditure/expense pro rata over the policy or contract

term. The entity should also accrue additional premiums or refunds on the basis of the group's experience to date, which should include provisions for the ultimate cost of reported and unreported claims before the financial statement date, whether reported or unreported. (The entity should disclose (a) that it is insured under a retrospectively rated policy and (b) that premiums are accrued based on the ultimate cost of the experience to date of a group of entities.) If the entity cannot estimate losses from reported or unreported claims as indicated in paragraphs 53 through 57, it should disclose the existing contingency in the notes to the financial statements in accordance with paragraph 58.

Policyholder or Pool Dividends

75. If an entity receives or is entitled to receive a policyholder dividend or return of contribution related to its insurance or pool participation contract, that dividend should be recognized as a reduction of expenditures/expenses at the time the dividend is declared.

Entities Providing Claims Servicing or Insurance Coverage to Others

76. If an entity provides insurance or risk management coverage *separate from its own risk management activities* to individuals or organizations outside the governmental reporting entity[13] and there is material transfer or pooling of risk among the participants, that activity should be accounted for as a public entity risk pool (paragraphs 18 through 50). If an entity provides risk transfer or pooling coverage *combined with its own risk management activities* to individuals or organizations outside its reporting entity, those activities should continue to be reported in the general fund or an internal service fund (paragraph 63) only as long as the entity is the predominant participant in the fund. If the entity is not the predominant participant in the fund, then the combined activities should be reported as a public entity risk pool, using an enterprise fund and the accounting and reporting requirements in paragraphs 19 through 50. If an entity performs *claims-servicing functions,* not insurance functions, for individuals or organizations that are not a part of the governmental reporting entity, amounts collected or due from those individuals or organizations and paid or to be paid to settle claims should be reported as a net asset or liability on an accrual basis, as appropriate. The operating statement should report claims-servicing revenue and administrative costs as discussed in paragraph 51.

[13]The governmental reporting entity is the oversight unit and all related component units, if any, combined in accordance with Codification Section 2100, "Defining the Reporting Entity."

Entities Other Than Pools—Disclosures

77. The following information should be disclosed in the notes to the financial statements, if applicable:

a. A description of the risks of loss to which the entity is exposed and the way(s) in which those risks of loss are handled (for example, purchase of commercial insurance, participation in a public entity risk pool, risk retention).[14]
b. A description of significant reductions in insurance coverage from coverage in the prior year by major categories of risk. Also indicate whether the amount of settlements exceeded insurance coverage for each of the past three fiscal years.
c. If an entity participates in a risk pool, a description of the nature of the participation, including the rights and the responsibilities of both the entity and the pool.
d. If an entity retains the risk of loss:[15]
    (1) The basis for estimating the liabilities for unpaid claims.
    (2) The carrying amount of liabilities for unpaid claims that are presented at present value in the financial statements and the range of discount rates used to discount those liabilities.
    (3) The aggregate outstanding amount of claims liabilities for which annuity contracts have been purchased in the claimants' names and for which the related liabilities have been removed from the balance sheet. (Annuity contracts used to settle claims for which the claimant has signed an agreement releasing the entity from further obligation and for which the likelihood that the pool will be required to make future payments on those claims is remote should not be included in this disclosure.)
    (4) A reconciliation of changes in the aggregate liabilities for claims for the current fiscal year and the prior fiscal year, in the following tabular format:
        (a) Amount of claims liabilities at the beginning of each fiscal year.
        (b) Incurred claims, representing the total of a provision for events of the current fiscal year and any change (increase or decrease) in the provision for events of prior fiscal years.
        (c) Payments on claims attributable to events of both the current fiscal year and prior fiscal years.
        (d) Other. (Provide an explanation of each material item.)
        (e) Amount of claims liabilities at the end of each fiscal year.

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[14]If commercial insurance is purchased in an amount that is insignificant to the entity's risk of loss, the entity is considered to have effectively retained that risk of loss.

[15]Use of an internal service fund is considered to be risk retention, not risk transfer, because the entity as a whole has retained the risk of loss.

Level of Disclosure

78. The financial statement preparer should use judgment in determining the level of disclosures presented. The disclosures required by this Statement may be made for the entity as a whole. However, there may be circumstances when aggregate disclosures are misleading and, in those circumstances, additional or separate presentation should be made by fund or fund type. In addition, there may be circumstances under which disclosures by fund or fund type may provide more useful information than disclosures presented in the aggregate. Additional or separate presentation by fund or fund type is not precluded for any disclosure required by this Statement. If a pool included in the oversight entity's combined financial report issues its own separate report, the combined report should emphasize oversight entity disclosures about its participation in a pool and provide reference to the separate report of the pool.

Component Unit Presentations

79. Component units that participate in their oversight entity's risk management internal service fund should make the disclosures required by paragraph 77a and 77b in their separately issued component unit financial statements. The component unit should also disclose the fact that the unit participates in the fund, include a description of the nature of that participation, and state the rights and responsibilities of both the unit and the oversight entity.

Subsequent Events

80. After the date of an entity's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred *after* the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. Disclosure of this kind of loss or loss contingency may be necessary to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements should indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements for which the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had

occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements.

EFFECTIVE DATES AND TRANSITION

Pools

81. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 1990. Earlier application is encouraged. Adjustments resulting from a change to comply with this Statement should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated. If restatement of financial statements for prior periods presented is not practicable, the cumulative effect of applying this Statement should be reported as a restatement of beginning pool equity for the earliest period restated. In the period that this Statement is first applied, the financial statements should disclose the nature of any restatement and its effect.

Entities Other Than Pools

82. The effective date and transition requirements for this Statement will be established by a future GASB Statement on financial reporting. As discussed in paragraphs 14 and 15, the Board intends that standards resulting from the MFBA ED and the financial reporting project, and the standards in this Statement, be implemented at the same time. The August 14, 1989 MFBA ED proposes that its requirements be effective for financial statements for periods beginning after June 15, 1993. However, early application of this Statement is permitted. Entities other than pools that elect early application and report their risk management activities in the general fund should do so within the constraints of the modified accrual basis of accounting. That is, long-term claims liabilities should continue to be reported in the general long-term debt account group. Entities that elect to apply this Statement early and report their risk management activities in an internal service fund should report long-term claims liabilities currently reported in the general long-term debt account group as liabilities of the internal service fund and deduct those liabilities from internal service fund beginning retained earnings at the date the Statement is applied. Governmental fund expenditures for risk management should be recognized to the extent that they will be liquidated with expendable available financial resources. Early application is encouraged for enterprise funds.

83. Current generally accepted accounting principles—as set forth in Codification Section C50—continue to apply to all state and local governmental entities. That section requires entities to recognize loss liabilities and related expenditures/expenses in conformity with FASB Statement 5, subject to the use of the modified accrual basis of accounting for governmental funds and expendable trust funds.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by unanimous vote of the five members of the Governmental Accounting Standards Board:

James F. Antonio, *Chairman*
Martin Ives, *Vice-Chairman*
Philip L. Defliese
W. Gary Harmer
Elmer B. Staats

Appendix A

BASIS FOR CONCLUSIONS

84. This appendix discusses factors considered significant by members of the Board in reaching the conclusions in this Statement. It includes descriptions of alternatives considered by the Board with reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

Responses to Discussion Memorandum and Exposure Draft

85. In September 1987, the Board issued a Discussion Memorandum (DM), *Accounting and Financial Reporting for Risk Management Activities*, that asked for comments on a number of issues for risk pools and for governmental entities other than pools. Responses were received from ninety-five individuals, firms, and organizations. In December 1988, after considering the views presented in the DM responses, the Board issued an Exposure Draft (ED) of a proposed Statement, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues.* The Board received sixty-six letters of comment on the ED, the majority of which generally supported the provisions of the ED. However, certain changes have been made to the proposed Statement as a result of respondents' recommendations. The Board also received assistance on this project from its Risk Management and Insurance Issues Task Force and the Public Risk Management Association's (PRIMA) Accounting Standards and Reporting Guidelines Working Group. The Board appreciates the work of both groups.

Transfer of Risk

86. The introductions to the ED and to this Statement discuss the concept of *transfer of risk* and give examples of situations that may exist. However, those paragraphs do not provide a *definition* of that term. A significant minority of ED respondents commented on the absence of a definition and urged the Board to provide either a definition or a list of circumstances that would connote risk transfer. Others described their particular situation and asked whether risk had been transferred. However, the Board noted in preparing the ED and this Statement that there are many variables that can exist in the composition of public entity risk pools or in simple contracts with pools and commercial insurance concerns. These variables make it difficult to provide a simple definition of transfer of risk, short of writing a "cookbook" that encompasses all imaginable situations. The Board

notes that providing such guidance is not a good substitute for preparer judgment. Accordingly, no guidance has been provided beyond the discussion originally presented in the ED.

Public Entity Risk Pools

Applicability of FASB Statement 60

87. The accounting and reporting requirements in paragraphs 19 through 49 of this Statement are those of FASB Statement 60, as amended by FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, the current standards for private insurance companies issuing short-duration contracts. Paragraphs 19 through 49 do not change the provisions of those FASB Statements. Additions, such as the requirements in paragraph 21 to show reservations of pool equity for future catastrophe losses, have been made to accommodate environmental factors that affect public entity risk pools and that do not exist in the private sector. Other changes, such as the expansion of paragraph 22 to discuss *probability* of IBNR losses provide clarification on the application of Statement 60.

88. Many public entity risk pools provide services that pool participants may have previously purchased from commercial insurance companies. Some Board members believe the kind of services a risk pool provides—not its organizational form—should determine the accounting and reporting requirements. Whether insurance against risk of loss is provided by the private sector or the public sector, the substance of the transaction is the same.

89. These Board members believe that public entity risk pools are insurance activities that happen to be conducted in the public sector. Pool financial statements are often reviewed by people who also review the financial statements of commercial insurers. For example, pool participants use pool financial statements as one means of evaluating the desirability of continued pool participation. Public entity risk pools compete against commercial insurers in the reinsurance and capital markets. Some risk pools are also subject to the scrutiny of their respective state insurance commissioners. Because the activities of public entity risk pools are similar to those of commercial insurers and because financial statements of the two types of entities are sometimes compared, these

Board members believe it is both prudent and desirable to maintain consistent accounting and financial reporting standards for insurance activities to the greatest extent possible.

90. Other Board members approached this issue from a different perspective. Without necessarily agreeing or disagreeing with the above, they reviewed the accounting and financial reporting requirements of FASB Statement 60 and considered them generally to be acceptable guidance for public entity risk pools.

91. Several respondents to the ED expressed concern about the use of FASB Statement 60 because it adds yet another set of specialized accounting principles to the combined general purpose financial reports of governments. In general, they believe specialized reporting complicates and confuses users of combined governmental financial reports. However, a significant majority of the ED respondents who either directly or indirectly commented on the use of FASB Statement 60 agree with its use.

92. One area in which FASB Statement 60 differs in some respects from governmental accounting is that of investment valuation; the primary differences are in the valuation of equity securities and the treatment of unrealized gains and losses on those securities. The Board discussed whether public entity risk pools should value their investments like other governmental entities or like commercial insurers. Although some Board members preferred alternative accounting, the consensus was that, as a practical matter, differences in the reported investment values of public entity risk pools using either FASB Statement 60 or governmental guidance should be minor because equity securities typically are a relatively minor component of a pool's investment portfolio. As a result, the Board did not believe there was sufficient reason to deviate from the guidance contained in FASB Statement 60. A majority of the ED respondents support this position. However, some respondents who commented on the proposed requirements for both pools and entities other than pools stated that they believe accounting for investments should be uniform regardless of who holds the investments. The Board notes that this issue exists not only for investments held to finance claims, but also for many other types of investments, such as those held to finance pension liabilities. The Board plans to consider this broader topic at a later date.

Premiums Collected in Anticipation of Future Catastrophe Losses

93. Pools sometimes collect a premium or required contribution that is specifically identified as being collected for future catastrophe losses. The Board considered three alternatives for accounting for and reporting these premiums:

a. Report this amount as revenue and unrestricted equity over the contract period, as required by FASB Statement 60.
b. Report this amount as revenue and restricted equity over the contract period.
c. Defer revenue recognition until the event that results in the catastrophe loss actually occurs.

94. The Board rejected the third alternative and adopted a variation of the second because it believes the service provided (risk coverage) is limited to the duration of the contract and, as a result, the revenue recognition criteria are met over the contract period. Although the Board is concerned about the practical difficulties with determining when a catastrophe covered by the extra premium has occurred, it nevertheless believes that those who participate in the pool ought to have information about what portion of pool equity is the result of "normal" operations and what is the result of additional premiums collected for anticipated future catastrophe losses.

95. The ED proposed that equity resulting from these participation contributions should be reported as designated equity, noting that this treatment would enable pool participants to determine the status of premiums collected in anticipation of future catastrophe losses. Responses to the ED made it clear that there is confusion over the meaning of the terms *designation* and *reserve.* In addition, many of those commenting on the proposed requirement opposed it. Based on this, the Board concluded that these amounts should be separately identified only as reserves of pool equity and defined "reserve" as something that is contractually restricted for a specific future use or legally restricted for a specific use by an organization or individual *outside the entity*—in this case, pool participants. In addition, the ED proposed disclosure of a reconciliation of the activity in the designated balance during the year. The Board dropped this disclosure requirement, noting that changes in reserves must, by definition, be in accordance with the pool's agreement with its participants.

Recognition of Incurred But Not Reported Claims

96. Claims cost recognition requirements presented in the ED were taken without modification from FASB Statement 60. However, some respondents noted opposition to reporting claims liabilities for incurred but not reported (IBNR) losses. Some noted that the proposal would require reporting liabilities that are not measurable with sufficient precision to be reliable. Others noted that liabilities for pools should be recognized in accordance with FASB Statement 5. The Board notes that the requirements of that FASB Statement *do* apply to IBNR measurement and that this appears to be a point of confusion in practice. To eliminate this confusion, the Board appended the requirements of FASB Statement 5—losses must be probable and reasonably estimable--to the requirements of paragraph 22 of this Statement. This addition is in no way intended to limit current IBNR accruals. Others noted confusion about what types of accruals should be included in IBNR. Footnote 5 of this Statement provides the Board's detailed definition of IBNR.

Discounting

97. In its ED and in this Statement, the Board concluded that the practice of discounting claims liabilities should be neither mandated nor prohibited because the effects of discounting in the area of claims and judgments are not yet fully understood. Board members were particularly concerned about discounting a liability that is a relatively "soft" estimate because it may imply a precision in the determination of the nondiscounted liability that does not exist. The majority commenting on the Board's decision to allow an option to discount agreed with this decision. However, several ED respondents urged the Board to reconsider its position, noting that it is important that the Board eliminate options in all of its standards. Others opposed discounting in any circumstances. In October 1988, the FASB added a project on interest methods to its agenda. That project is addressing a broad range of issues, including the use of present-value or discounted accounting measures, related measurement techniques based on interest, when and how interest methods should be used, and what rates should be used. The FASB expects to issue a neutral discussion document on the project sometime in 1990. The GASB and its staff are monitoring this project and will consider whatever information the project produces. Until this work is complete, the Board believes that either mandating or prohibiting the practice as it applies to nonstructured settlements would be premature.

98. The Board considered three discount rate alternatives if claims liabilities are discounted: a settlement rate, an investment rate, and a borrowing rate. Some believe the objective of discounting should be to report the claim liability at its market value, and that the settlement rate is the best indication of that rate. Others believe that net claims expense is partly a function of the earnings on assets obtained to pay claims expense, and that the investment rate of return on those assets is a more appropriate rate to use for discounting. Again, several ED respondents urged the Board to reconsider its position, noting that it is important that the Board eliminate options in all of its standards. However, because of the continuing research on discounting and the likelihood that the two rates would not be materially different for governmental pools, the Board believes that both rates ought to be considered and that either rate would be acceptable.

Annuity Contracts

99. The Board considered two alternatives for accounting for an annuity contract purchased to satisfy a claim liability. One alternative is to record the annuity contract on the balance sheet; the other is not to record the annuity contract and to remove the claim liability from the balance sheet. The Board concluded that purchasing an annuity contract in the claimant's name is analogous to a debt defeasance, wherein neither the asset nor the liability is reported on the balance sheet. However, unless the claimant has signed an agreement releasing the governmental entity from further obligation and the likelihood that the entity will be required to make future payments on those claims is remote, the debt has not been retired and the pool may have a contingent liability. For this reason, the Board believes note disclosure of the outstanding amount of the liability over the life of the contract is appropriate.

Acquisition Costs

100. Paragraphs 28 through 30 require pools to capitalize and amortize the cost of acquiring insurance contracts. Paragraph 49c requires disclosures about the effects of that accounting. Policy acquisition costs include commissions, salaries of certain employees involved in underwriting and policy issue functions, and inspection fees. This requirement is taken from FASB Statement 60, and this Board considers it to be generally accepted guidance for public entity risk pools. Several ED respondents commented that they believe the cost of identifying, capitalizing, and amortizing these amounts would exceed the benefits. The Board agrees that this may be true in some circumstances but

notes that, as with all requirements in this Statement, the accounting is not required if amounts are not material.

Reinsurance

101. This Statement requires the same accounting for reinsurance transactions as does FASB Statement 60. However, several ED respondents expressed concern about the potential for abuse of reinsurance by public entity risk pools. The Board is aware of this concern but does not believe it can be addressed in an accounting standard. The Board notes that both pools and governments should be aware that they cannot discharge their obligations to the insureds through reinsurance, but can only obtain the right to reimbursement from the reinsurer. Therefore, the governmental entity faces the risk that the reinsurer may not have the financial capacity or stability to meet its obligations when they are due. The accounting should reflect these circumstances and report situations in which it is probable that risk of loss will revert to the governmental entity.

Disclosures

102. For purposes of its ED, the Board reviewed the disclosure requirements for commercial property and casualty insurers contained in FASB Statement 60 and Securities and Exchange Commission (SEC) Industry Guide 6, "Disclosures concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters," in an attempt to identify those disclosures that would provide the most useful information to pool participants and other users of the pool financial reports. The Board concluded that users of pool financial reports would benefit from a combination of both sets of disclosures. The Board further concluded that a description of the pooling arrangement and an analysis of claims liabilities by type of contract would help financial report users (particularly pool participants) gain a better understanding of the pool's operations.

103. To reduce the detail contained in the general purpose financial statements, the Board proposed in its ED that some of the disclosures, consisting primarily of ten-year claims development information based on SEC reporting requirements, be reported as required supplementary information (RSI) immediately following the notes to the pool's financial statements. Several respondents questioned the requirement because it would present claims development data on a cumulative basis, without reference to the policy year. As a result, the information would not show true development in claims liabilities because increases in incurred claims estimates would be reported in the year the estimate changes

without reference to the year the claim occurred. In addition, the ED requirement would only disclose information about claims liabilities outstanding at year-end. Because the schedule starts with liabilities *accrued* at the end of each period, it omits expenses for claims paid in the period in which they are asserted. Although this information would not have affected the development trends, those respondents also had suggested that pools be required to provide information about premium and investment income for each of the past ten years for comparison to incurred losses. Making a comparison of premium and investment income to claims liabilities would be misleading when this component of loss *expense* is omitted. The Board agrees with those respondents and, working with its Risk Management and Insurance Issues Task Force and others, agreed on a revised schedule of ten-year information as required by this Statement that presents both premium and investment income on a fiscal year basis and information about incurred and paid claims liabilities on a *policy-year basis.* A policy-year basis assigns incurred losses and claim adjustment expenses to the year in which the event that triggered coverage under the pool insurance or participation contract occurred. Generally, pool administrators or their actuaries prepare information on this basis for purposes of determining loss reserves. For this reason, the information should be easier to obtain than the information that would have been required to be presented by the ED. In addition, this Statement permits preparers to provide *only* those data that are currently available. It does not require recreating any data retroactively. Although the Board notes that the information required is no longer comparable to the data required for comparable insurance entities registered under the SEC, it believes that the quality of the new data outweighs this disadvantage.

104. Many ED respondents opposed the proposed ten-year requirement not because of the quality of the information, but because it would be reported in the RSI category. Although some recommended that the ten-year data be dropped entirely, others noted that if the information is important, it should be presented in the notes to the financial statements, not as RSI. Still others recommended presenting the information in the statistical section of a pool's comprehensive annual financial report. Many who oppose the category of RSI note that currently there is some confusion about generally accepted auditing standards for RSI. Others note that the GASB has not formally defined the category or established standards for its use or placement, even though RSI is required by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers.* The Board recognizes the issues raised by those who are concerned about the definition, use, and auditability of this category of data. However, the Board is more persuaded by the fact that many in the public entity risk pool community

believe that ten-year claims development data as revised in this Statement are an important component of pool financial reports. In fact, the data provide pertinent details about the single largest amount reported in pool balance sheets—the claims liability. Accordingly, the Board concluded in this Statement that the data, as revised, should continue to be presented as RSI whenever a public entity risk pool presents general purpose financial statements.

105. Other ED respondents commented that they believe the disclosures proposed for pools in general are excessive. Some are troubled that the Board chose to require components of both FASB Statement 60 and SEC requirements. However, the Board continues to believe those disclosures are appropriate and has made only minor changes in the level of disclosure requirements in this Statement.

Pools Not Involving Transfer or Pooling of Risk

106. The Board concluded that pools that function only as claims servicers should report differently from those pools in which there is some transfer or pooling of risk because the substance of the two transactions is fundamentally different. As a provider of claims servicing, the pool acts as an agent for the individual participant. It does not have a risk of loss arising from incurred claims. As a result, this Statement requires that those pools account in an enterprise fund for only administrative costs and related revenues.

Entities Other Than Pools

Use of FASB Statement 5

107. The accounting and reporting requirements in paragraphs 53 through 56, paragraph 58, and footnote 11 of this Statement are those of FASB Statement 5, as amended by FASB Statements No. 16, *Prior Period Adjustments,* and No. 71, *Accounting for the Effects of Certain Types of Regulation,* and interpreted by FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* the current standards for private-sector companies. This Statement does not change the provisions of those FASB Statements and Interpretation. Their requirements are repeated in this Statement to make the document complete in its own right and to make it easier to use.

Liability and Expenditure Recognition and Measurement and Use of an Internal Service Fund

108. In considering the alternatives for recognizing and measuring expenditures/expenses and liabilities resulting from risk financing, the Board noted that risks can be financed through either insurance (risk transfer) or noninsurance (risk retention) or some combination of the two. The Board also noted that risk retention may or may not be accompanied by the setting aside of funds specifically (for example, through an internal service fund) to cover losses.

109. The Board is also aware that *how* risk is financed has significant financial and public policy implications. Transfer of risk of loss to a third party requires a cash disbursement when risk is transferred. It also results in spreading the costs of those risks over time. For example, fire insurance might be paid for a period of twenty years, but a fire might take place only in the tenth year. Insurance against certain torts might require relatively level premiums each year, but the number of claims may vary from year to year and the severity of individual claims may also vary from year to year. When risk is retained, however, there are no cash disbursements for insurance, but there are disbursements for claims settlements and judgments. In the absence of insurance, there is no leveling of premiums to cushion against catastrophic events or year-to-year fluctuations in the severity of claims.

110. In GASB Concepts Statement 1, the Board asserted the notion of interperiod equity: Financial reporting should help users assess whether current-year revenues are sufficient to pay for the services provided that year. However, a catastrophic event resulting in a loss cannot be considered as a "service," and torts, although they often occur during the course of providing services, cannot be considered as services themselves. Some Board members were concerned that recognizing and measuring claims expenditures/expenses solely on the basis of the incurrence of events giving rise to claims might distort the measurement of interperiod equity; indeed, some expressed the view that procedures for leveling the effects of those events were needed to assure the achievement of interperiod equity.

111. Some Board members also expressed concern about the difficulty experienced by those who retain risk of making reasonably accurate measurements for certain types of claims (for example, contentious matters likely to go to litigation and unlikely to be adjudicated or settled for many years, or claims incurred but not asserted as of the balance sheet date). These members suggested that measurements made in accordance with the

provisions of FASB Statement 5 were, at best, educated guesses. Some ED respondents concurred with this view.

112. Other Board members believe that FASB Statement 5 has stood the test of time in private-enterprise financial reporting. In their view, the guidance contained in FASB Statement 5 is as good as could be developed, at least for measuring the balance sheet liability.

113. The Board considered two ways of recognizing and measuring the claims expenditures/expenses and liabilities when risk is retained: FASB Statement 5 and an actuarial method based on claims experience and current trends that would result in level annual expenditure/expense amounts. In addition, the Board considered whether the expenditure/expense, regardless of how measured, could also include a provision for future catastrophe losses.

114. The Board concluded that the factors discussed in paragraphs 108 through 112 could be accommodated best by (a) using FASB Statement 5 as guidance to recognize and measure the claims liabilities and (b) allowing an option for recognizing and measuring the expenditure/expense on some other basis, provided that an internal service fund is used. The option allows the internal service fund interfund charge to be determined either in accordance with the provisions of FASB Statement 5 or by use of an actuarial method that results in level annual charge amounts and also allows entities to include a reasonable premium for expected future catastrophe losses. When the option to use an actuarial method that results in level annual charge amounts is exercised, adjustments over a reasonable period of time are required so that revenues and expenses of the internal service fund are approximately equal. If an internal service fund is not used, fund expenditures/expenses in the aggregate are required to be measured in accordance with the provisions of FASB Statement 5, as discussed in paragraphs 53 through 57 of this Statement.

115. The Board believes the option is justified not only by the arguments presented in paragraphs 108 through 112, but also by the fact that internal service funds take on some characteristics of third-party insurers. For example, internal service funds provide for periodic transfers of cash so that assets are accumulated and earmarked specifically to pay for claims. Also, use of internal service funds may result in a pooling of risk among funds. Because this Statement requires measurement of the internal service fund liability

in accordance with the provisions of FASB Statement 5, the financial statement user will be able to readily assess the financial effect of using these actuarial procedures by reviewing the internal service fund designation for future catastrophe losses and net equity.

116. A large majority of ED respondents expressing a view either directly or by inference on FASB Statement 5 agree with its use for governmental entities. Although agreeing with its use, several respondents expressed concern that reporting an estimated loss on a claim may jeopardize the outcome of the lawsuit. Others noted that their legal staffs are reluctant to make claims estimates because they fear it will compromise the litigation. The Board agrees that this area is a sensitive one. In fact, the American Bar Association's 1975 "Statement of Policy regarding Lawyers' Responses to Auditors' Requests for Information" provides that disclosure of confidential information (even with client consent) to a third party (such as an auditor) may significantly impair the client's ability to maintain the confidentiality of information in other contexts. Lawyers are cautioned that in evaluating claims, "an adverse party may assert any evaluation of potential liability as an admission." Having noted this, the Board also notes that the estimation process required by FASB Statement 5 has been in place since 1975 in the private sector. The Board believes preparers, attorneys, and auditors will be able to work together to obtain a reasonable solution to this issue. For this reason, the Board requires use of the basic requirements of FASB Statement 5 for measurement of claims liabilities.

117. A minority of ED respondents disagreed with the ED's proposal to permit internal service funds to charge other funds of the entity an amount for future catastrophe losses. Some noted that the proposal would allow governments to manipulate the operating results of other funds. Others oppose it because it results in a charge in the other funds that is not in accordance with FASB Statement 5. Only one respondent opposed the companion proposal that would allow internal service funds to base their charges to other funds on an actuarial funding method or historical cost information so that revenues and expenses in the fund are approximately equal over time. The Board considered these comments, but continues to believe the proposal set forth in the ED is appropriate for the reasons given in paragraphs 108 through 112. Accordingly, no changes were made to this provision from the ED stage to this Statement.

Fund Type to Use

118. The Board considered whether an entity's risk financing activities accounted for in a single fund should be accounted for in the general fund, an internal service fund, or a legally restricted trust fund. The Board concluded that use of a legally restricted trust fund is not appropriate because of the absence of a trust relationship. The Board believes that if an entity uses a single fund to account for its risk financing activities, that fund should be either the general fund or an internal service fund.

119. A majority of the ED respondents agree with this option. However, a significant minority of respondents recommended that the Board require use of internal service funds. They note the perceived benefit of being able to more easily review and evaluate the risk financing function when all related activities are isolated in one dedicated fund. The Board agrees that an internal service fund may be more appropriate for these reasons. However, consistent with the objective of minimizing the number of funds used by a governmental entity, this Statement does not mandate use of internal service funds. Instead, the Board believes use of an internal service fund to account for risk financing activities should be at the entity's option.

Discounting

120. See paragraphs 97 and 98; the considerations about discounting are the same for both pools and entities other than pools.

Internal Service Fund Charges

121. NCGA Statement 4 required that interfund charges from the internal service fund should be accounted for as operating or residual equity transfers, not as expenditures/expenses and revenues; the NCGA did not believe risk of loss could be transferred to a single insurer fund. Because this treatment of interfund payments was inconsistent with the accounting for payments to other kinds of internal service funds, the effective date for this particular provision of NCGA Statement 4 was extended indefinitely by NCGA Interpretation 11, *Claim and Judgment Transactions for Governmental Funds.* However, this extension did not preclude governments from presenting claims and judgments transactions in accordance with NCGA Statement 4.

122. This Statement requires interfund charges from the internal service fund for insurance to be reported as revenues and expenditures/expenses. The Board believes these

interfund charges should be reported as quasi-external transactions because (a) the internal service fund has some characteristics of a third-party insurer (see paragraph 115) for the other funds of the entity, (b) interfund payments to other kinds of internal service funds are treated as quasi-external transactions, (c) reducing the number of interfund transfers will make the financial statements easier to understand, and (d) an expenditure/expense will be reported for the increase in claims liabilities when an internal service fund is not used.

Pool Participation without Transfer or Pooling of Risk and Other Insurance-Related Transactions

123. The Board considered two alternatives for expenditure recognition when an entity participates in a pool but there is no transfer of risk to the pool or pooling of risk among pool participants. One alternative was to base the expenditure amount on the amount of the entity's premium; the other alternative was to base it on the criteria of paragraphs 53 through 57 of this Statement.

124. The Board believes that, in the absence of a transfer or pooling of risk, the entity has retained the risk of loss and the service the entity is purchasing from the pool is claims servicing, not insurance. Because the entity has retained the risk of loss, it should base expenditure/expense recognition on the criteria of paragraphs 53 through 57 of this Statement (just as it would in the absence of pool participation), not on cash payments to the pool. This conclusion is consistent with the treatment for similar arrangements with private-sector organizations (either commercial insurers or organizations) that perform only claims-servicing functions.

125. Likewise, if an entity has a claims-made insurance policy that has not been renewed and tail coverage has not been purchased or if the entity has a retrospectively rated insurance policy, the Board believes the criteria of this Statement should be applied to the extent that risk has not been transferred to an independent third party.

Entities Providing Insurance Coverage to Others

126. If an entity provides insurance or risk management coverage (such as workers' compensation insurance) *separate from its own risk management activities* to individuals or organizations outside the governmental reporting entity and there is material transfer or pooling of risk among the participants, this Statement requires that the activity be accounted for as a public entity risk pool. The Board believes this type of arrangement is

no different from other stand-alone public entity risk pools; accordingly, the same guidance should apply. Similarly, this Statement requires that if an entity provides risk transfer or pooling coverage *combined with its own risk management activities* to individuals or organizations outside its reporting entity, those combined activities should be reported as a public entity risk pool unless the entity is the predominant participant in the fund. The Board is aware that application of this requirement and of the term *predominant* will require preparer and auditor judgment. This will be particularly true in cases in which an entity reports its own risk management activities in the general fund rather than an internal service fund. The Board expects in these cases that the greater the participation of organizations outside the reporting entity, the more likely it is that the activity will be transferred from the general fund to an internal service or enterprise fund. This is because of the potential effect that reporting underwriting earnings in the general fund would have on the operating results of the fund that is generally considered to provide information about a government's own day-to-day activities.

Disclosures

127. The disclosures required by this Statement for entities other than pools are based, in part, on the report of the AICPA Task Force on Disclosure of Insurance. That report provides a useful framework for entity risk financing disclosures. When an entity retains the risk of loss, this Statement also requires presentation of a claim liability reconciliation (also required for public entity risk pools) because entities that retain risk of loss have measurement concerns similar to those of insurance enterprises.

128. Some respondents commented that, in general, disclosures for entities other than pools seem excessive. Although conscious of the growing concern about excessive footnote disclosures in governmental financial reporting, the Board nevertheless believes certain additional disclosures are necessary because of the potential magnitude of risk financing and related insurance transactions in relation to the entity's financial statements taken as a whole. These disclosures are also necessary because of the changing nature of risk financing and the potential for liability in an increasingly litigious society.

Effective Date and Transition

129. For public entity risk pools, the Board concluded that this Statement should be applied retroactively by restatement of prior periods. This requirement will result in reporting comparability among those enterprises immediately following its application.

The Board does not believe the cost of requiring this application will exceed its benefit. For governmental entities other than pools, the Board has decided to make the effective date of this project and the projects on measurement focus and basis of accounting (MFBA) for governmental funds and on pension accounting and reporting simultaneous. The proposed effective date in the recently issued revised ED on the MFBA project is for fiscal periods beginning after June 15, 1993. However, the Board also notes that many governmental entities have recently put internal service funds in place for their risk management activities. Current accounting requirements (Codification Section C50) limit the use of insurance internal service funds to governmental funds. In addition, some believe that section requires transfers between governmental funds and an insurance internal service fund to be reported as residual equity transfers if they exceed the FASB Statement 5 amount. The Board believes that neither of these restrictions is appropriate for the use of insurance internal service funds. Allowing early implementation of this Statement eliminates the need to operate within these restrictions. In addition, the Board notes that implementation is possible within the framework of the modified accrual basis of accounting for governmental funds.

Appendix B

GLOSSARY

130. This appendix defines certain terms used in this Statement.

Acquisition costs

Costs incurred in the acquisition of new and renewal insurance or pool participation contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of contracts (for example, certain underwriting and policy issue costs, and inspection fees).

Act of God

An event beyond human origin or control—natural disasters. Lightning, windstorms, and earthquakes are examples.

Actuarial method

Any of several techniques that actuaries use to determine the amounts and timing of contributions needed to finance claims liabilities so that the total contributions plus compounded earnings on them will equal the amounts needed to satisfy claims liabilities. It may or may not include a provision for anticipated catastrophe losses.

Annuity contract

A contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life.

Catastrophe

A conflagration, earthquake, windstorm, explosion, or similar event resulting in substantial losses *or* an unusually large number of unrelated and unexpected losses occurring in a single period.

Cede

To transfer all or part of an insurance risk to another enterprise through reinsurance.

Claim

A demand for payment of damages or a policy benefit (for insured risks) because of the occurrence of an event, such as the destruction or damage of property and related deaths or injuries.

Claim adjustment expenses

Expenses incurred in the course of investigating and settling claims. Allocated claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Unallocated claim adjustment expenses include 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.

Claims-made policy or contract

A type of policy that covers losses from claims asserted (reported or filed) against the policyholder during the policy period, regardless of whether the liability-imposing events occurred during the current or any previous period in which the policyholder was insured under the claims-made contract or other specified period before the policy period (the policy retroactive date).

Cost recovery method

Under the cost recovery method, premiums are recognized as revenue in an amount equal to estimated claims costs as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time.

Deposit

Money placed with a banking or other institution or with a person, sometimes for a specific purpose.

Deposit method

Under the deposit method, premiums are not recognized as revenue and claims costs are not charged to expense until the ultimate premium is reasonably estimable; recognition of revenue is postponed until that time.

Discounting

A method used to determine the present value of a future cash payment or series of payments that takes into consideration the time value of money.

Excess insurance (insurer)

The transfer of risk of loss from one party (the insured) to another (the excess insurer) in which the excess insurer provides insurance (as defined in this glossary) in excess of a certain, typically large amount. For example, a public entity risk pool may purchase excess insurance to transfer risk of aggregate losses above $5 million by its pool participants.

Incurred but not reported (IBNR) claims

Claims for insured events that have occurred but have not yet been 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 events 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.

Incurred claims

Claims (losses) paid or unpaid for which the entity has become liable.

Insurance

The transfer of risk of loss from one party (the insured) to another party (the insurer) in which the insurer promises (usually specified in a written contract) to pay the insured (or others on the insured’s behalf) an amount of money (or services, or both) for economic losses sustained from an unexpected (accidental) event during a period of time for which the insured makes a premium payment to the insurer.

Liability for claim adjustment expenses

The amount needed to provide for the estimated ultimate cost required to investigate and settle claims for insured events that have occurred on or before a particular date (ordinarily, the balance sheet date), whether or not reported to the governmental entity, public entity risk pool, or insurer at that date.

Liability for unpaid claims costs

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.

Maintenance costs

Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

Participation contract

A formal written contract between a public entity risk pool and a pool participant describing, among other things, the period, the amount of risk coverage the pool will provide for the participating governmental entity, and the required contribution the participant must pay for that coverage. (The term *policy* is used in the commercial insurance industry.)

Policy

A formal written contract of insurance between an insurer and an insured describing, among other things, the period and amount of risk coverage the insurer agrees to provide the insured.

Policyholder

The party to whom an insurance policy is issued and who pays a premium to an insurer for the insurer's promise to provide insurance protection.

Policyholder dividends

Payments made or credits extended to the insured by the insurer, usually at the end of a policy year, that result in reducing the net insurance cost to the policyholder. These dividends may be paid in cash to the insured or applied by the insured to reduce premiums due for the next policy year.

Policy-year basis

For disclosure purposes as used in this Statement, a method that assigns incurred losses and claim adjustment expenses to the year in which the event that triggered coverage under the pool insurance policy or participation contract occurred. For occurrence-based coverage for which all members have a common contract renewal date, the policy-year basis is the same as the accident-year basis. For claims-made coverages, policy-year basis is the same as the report-year basis.

Premium

The consideration paid for an insurance contract.

Premium deficiency

The amount by which 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 exceed related unearned premium revenue.

Probable

Used in the context of assessing estimated losses from claims, the future event or events confirming the fact that a loss has occurred are likely to occur.

Property and liability insurance

Insurance contracts that provide protection against (a) damage to, or loss of, property caused by various perils, such as fire and theft, or (b) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance companies also may issue accident and health insurance contracts. There is a broad insurance distinction between companies writing life and health insurance and those writing the property insurance or "nonlife" lines of fire, marine, casualty, and surety. Although no one definition has been fully established, some use the generic title "property and casualty" insurance, whereas others use "property and liability" insurance.

Public entity risk pool

A cooperative group of governmental entities joining together to finance an exposure, liability, or risk. Risk may include property and liability, workers' compensation, or employee health care. A pool may be a stand-alone entity or included as part of a larger governmental entity that acts as the pool's sponsor.

Reasonably possible

Used in the context of assessing estimated losses from claims, the chance of the future event or events occurring is more than remote but less than probable.

Reinsurance (reinsurer)

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.

Remote

Used in the context of assessing estimated losses from claims, the chance of the future event or events occurring is slight.

Reporting-form contract

A contract or policy in which the policyholder is required to report the value of property insured to the insurer at certain intervals. The final premium on the contract is determined by applying the contract rate to the average of the values reported.

Required contribution

The consideration a pool participant pays a public entity risk pool for a participation contract. (The term *premium* is used in the commercial insurance industry.)

Retrospective (experience) rating

A method of determining the final amount of an insurance premium by which the initial premium is adjusted based on actual experience during the period of coverage (sometimes subject to maximum and minimum limits). It is designed to encourage safety by the insured and to compensate the insurer if larger-than-expected losses are incurred.

Return of contribution

Payments made or credits extended to the participant by a public entity risk pool, usually at the end of a participation contract year, that result in reducing the participant's net participation contribution. These returns may be paid in cash to the participant or applied by the pool to reduce participation contributions due for the next participation contract year. (The term *dividend* is used in the commercial insurance industry.) Returns of contributions are distinguished from experience refunds in that returns are not determined based on the actual experience of an individual pool participant but, instead, on the experience of the pool as a whole or of a class of participants.

Risk

Defined variously as uncertainty of loss, chance of loss, or the variance of actual from expected results. Also, the subject matter of an insurance contract (for example, the insured property or liability exposure).

Risk management

The process of managing an organization's activities to minimize the adverse effects of certain types of losses. The main elements of risk management are risk control (to minimize the losses that strike an organization) and risk financing (to obtain finances to restore the economic damages of those losses).

Salvage

The amount received by a public entity risk pool from the sale of property (usually damaged) on which the pool has paid a total claim to the insured and has obtained title to the property.

Self-insurance

A term often used to describe an entity's retention of risk of loss arising out of the ownership of property or from some other cause, rather than transferring that risk to an independent third party through the purchase of an insurance policy. It is sometimes accompanied by the setting aside of assets to fund any related losses. Because no insurance is involved, the term *self-insurance* is a misnomer.

Settlement rate

The rate at which a monetary liability with uncertain terms can be settled or a monetary asset (receivable) with uncertain terms can be sold.

Structured settlement

A means of satisfying a claim liability, consisting of an initial cash payment to meet specific present financial needs combined with a stream of future payments designed to meet future financial needs, generally funded by annuity contracts.

Subrogation

The right of an insurer to pursue any course of recovery of damages, in its name or in the name of the policyholder, against a third party who is liable for costs of an insured event that have been paid by the insurer.

Tail

The length of time between the occurrence of an event giving rise to a claim and the actual reporting and eventual settlement of that claim.

Tail coverage

A type of insurance policy designed to cover claims incurred before, but reported after, cancellation or expiration of a claims-made policy. (The term *extended discovery coverage* is used in the commercial insurance industry.)

Tort

A wrongful act, injury, or damage (not involving a breach of contract) for which a civil action can be brought.

Type of contract

Classification of policies or participation contracts based on the nature of the coverages provided that distinguishes them as an identifiable class of contract. For example, types of contracts may include general liability, property, automobile liability, automobile physical damage, multiperil, and workers' compensation.

Underwriting

The process of selecting, classifying, evaluating, rating, and assuming risks.

Appendix C

CALCULATION OF POOL PREMIUM DEFICIENCIES

131. Paragraphs 34 through 36 of this Statement require pools to calculate and report premium deficiencies. Those paragraphs provide details on the types of costs that must be considered in this calculation. This appendix provides two examples of that calculation. (Note that single policies are used in these examples for simplicity. Paragraph 34 requires pools to group policies consistent with the pool's manner of acquiring, servicing, and measuring the revenue and expense elements of its contracts for purposes of making this calculation.)

Example I

Assume the following facts:

Premium or contribution amount		$100
Expected claim costs (¶22)	$ 85	
Claim adjustment expenses (¶23)	5	
Incurred maintenance costs (¶31)	5	
Capitalized acquisition costs (¶28–¶30)	10	
Expected dividends (¶32)[16]	5	
Anticipated investment income (¶35, fn 6)	(5)	
Total costs		105
Deficiency		(5)

Because the pool has capitalized acquisition costs of $10, the deficiency would be recognized in this example by expensing $5 of those costs when the deficiency is determined. If a deficiency did not exist, those costs would have been charged to expense over the course of the contract term in proportion to premium revenue recognized.

[16]As noted in paragraph 32, dividends are based on the experience of a class of policies, not on individual policy experience. Although it appears abnormal to report a dividend on a policy with a deficiency, assume for purposes of this example that the results of this particular class of policies are favorable.

Example II

Assume the same facts as in the previous example, except that expected claim costs are $105:

Premium or contribution amount		$100
Expected claim costs (¶22)	$105	
Claim adjustment expenses (¶23)	5	
Incurred maintenance costs (¶31)	5	
Capitalized acquisition costs (¶28–¶30)	10	
Expected dividends (¶32)	5	
Anticipated investment income (¶35, fn 6)	(5)	
Total costs		125
Deficiency		(25)

In this example, the pool would recognize the deficiency by charging the entire amount of capitalized acquisition costs of $10 to expense when the deficiency is determined. In addition, the pool would report a total claim and claim adjustment expense liability of $110 to report total expenses under the contract of $130.

Appendix D

ILLUSTRATIVE DISCLOSURES

132. This appendix illustrates disclosures required by this Statement (and only those required by this Statement). The facts assumed in these examples are illustrative only and are not intended to modify or limit the requirements of this Statement or to indicate the Board's endorsement of the policies or practices shown. Application of the provisions of this Statement may require disclosures and formats other than those illustrated here.

Illustration 1: Public Entity Risk Pools

Illustration 2: School District Participation in a Public Entity Risk Pool

Illustration 3: City Government with Some Risk of Loss Retained

Illustration 4: State Government with All Risks of Loss Retained

Illustration 5: City Government, All Risks Retained, Accounting in General Fund

Illustration 1: Public Entity Risk Pools

Public Insurance Fund
Notes to Financial Statements
Year Ended December 31, 19X8

Description of the Fund

The Public Insurance Fund (Fund) was organized in October 19W7 to provide a program of property and casualty and employee health and accident coverage for its member organizations. In accordance with Local Law XX-123(a)[k], all political subdivisions in the State of A are eligible to participate. The program's general objectives are to formulate, develop, and administer, on behalf of the member political subdivisions, a program of insurance, to obtain lower costs for that coverage, and to develop a comprehensive loss control program. Political subdivisions joining the Fund must remain members for a minimum of three years; a member may withdraw from the Fund after that time by giving six months' notice. Subdivisions applying for membership in the Fund may do so on approval of a two-thirds vote of the board of the Fund. Fund underwriting and rate-setting policies have been established after consultation with actuaries. Fund members are not subject to a supplemental assessment in the event of deficiencies. Annual premium increases are limited to 20% of the prior year's premium. If the assets of the Fund were to be exhausted, members would not be responsible for the Fund's liabilities. Fund members currently include 9 cities with populations ranging from 60,000 to 140,000 and 4 counties with populations ranging from 90,000 to 120,000 people.

A. Summary of Significant Accounting Policies

1. *Basis of accounting* (not illustrated).

2. *Valuation of investments* (not illustrated).

3. *Unpaid claims liabilities.* The Fund establishes claims liabilities based on estimates of the ultimate cost of claims (including future claim adjustment expenses) that have been reported but not settled, and of claims that have been incurred but not reported. The length of time for which such costs must be estimated varies depending on the coverage involved. Estimated amounts of salvage and subrogation and reinsurance recoverable on unpaid claims are deducted from the liability for unpaid claims. Because actual claims costs depend on such complex factors as inflation, changes in doctrines of

legal liability, and damage awards, the process used in computing claims liabilities does not necessarily result in an exact amount, particularly for coverages such as general liability. Claims liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation in the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. Adjustments to claims liabilities are charged or credited to expense in the periods in which they are made.

4. *Deferred policy acquisition costs.* Acquisition costs, which consist primarily of salaries, inspection and medical exam fees, and certain underwriting expenses, vary with, and are primarily related to, the issuance of new insurance policies. These costs are deferred and amortized on a straight-line basis over the life of the insurance contract. Deferred acquisition costs are reviewed periodically to determine if they are recoverable from future income, including investment income. If the deferred costs are not recoverable, they are charged to expense in the period of the review. Amortization of deferred costs in 19X8 was $133,000.

5. *Reinsurance.* The Fund uses reinsurance agreements to reduce its exposure to large losses on all types of insured events. Reinsurance permits recovery of a portion of losses from reinsurers, although it does not discharge the primary liability of the Fund as direct insurer of the risks reinsured. The Fund does not report reinsured risks as liabilities unless it is probable that those risks will not be covered by reinsurers. The amount deducted from claims liabilities as of December 31, 19X8 for reinsurance was $377,000.

B. Unpaid Claims Liabilities

As discussed in Note A, the Fund establishes a liability for both reported and unreported insured events, which includes estimates of both future payments of losses and related claim adjustment expenses. The following represents changes in those aggregate liabilities for the Fund during the past two years:

	19X8	19X7
	(in thousands)	
Unpaid claims and claim adjustment expenses at beginning of year	$1,421	$1,189
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	1,282	900
Increases in provision for insured events of prior years	649	540
Total incurred claims and claim adjustment expenses	1,931	1,440
Payments:		
Claims and claim adjustment expenses attributable to insured events of the current year	641	450
Claims and claim adjustment expenses attributable to insured events of prior years	904	758
Total payments	1,545	1,208
Total unpaid claims and claim adjustment expenses at end of the year	$1,807	$1,421

At year-end 19X8, $718,000 of unpaid claims and claim adjustment expenses are presented at their net present value of $576,000. These claims are discounted at annual rates ranging from 8 1/2 to 11 percent. Unpaid claims expenses of $249,000 are not reported in the 19X8 year-end balances because the Fund has purchased annuities in claimants' names to settle those claims.

Note: These tables should be presented immediately after the Fund's notes to financial statements.

REQUIRED SUPPLEMENTARY INFORMATION

Reconciliation of Claims Liabilities by Type of Contract

The schedule below presents the changes in claims liabilities for the past two years for the Fund's two types of contracts: property and casualty and employee health and accident benefits.

	Property and Casualty		Employee Health	
	19X8	19X7	19X8	19X7
	(in thousands)		(in thousands)	
Unpaid claims and claim adjustment expenses at beginning of the fiscal year	$762	$713	$659	$476
Incurred claims and claim adjustment expenses:				
Provision for insured events of the current fiscal year	513	360	769	540
Increases in provision for insured events of prior fiscal years	389	324	260	216
Total incurred claims and claim adjustment expenses	902	684	1,029	756
Payments:				
Claims and claim adjustment expenses attributable to insured events of the current fiscal year	256	180	385	270
Claims and claim adjustment expenses attributable to insured events of prior fiscal years	542	455	362	303
Total payments	798	635	747	573
Total unpaid claims and claim adjustment expenses at end of the fiscal year	$866	$762	$941	$659

Ten-Year Claims Development Information

The following table illustrates how the Fund's earned revenues (net of reinsurance) and investment income compare to related costs of loss (net of loss assumed by reinsurers) and other expenses assumed by the Fund as of the end of each of the last ten years. The rows of the table are defined as follows: (1) This line shows the total of each fiscal year's earned contribution revenues and investment revenues. (2) This line shows each fiscal year's other operating costs of the Fund including overhead and claims expense not allocable to individual claims. (3) This line shows the Fund's incurred claims (both paid and accrued) as originally reported at the end of the first year in which the event that triggered coverage under the contract occurred (called *policy year*). (4) This section of 10 rows shows the cumulative amounts paid as of the end of successive years for each policy year. (5) This section of 10 rows shows how each policy year's incurred claims increased or decreased as of the end of successive years. This annual reestimation results from new information received on known claims, reevaluation of existing information on known claims, as well as emergence of new claims not previously known. (6) This line compares the latest reestimated incurred claims amount to the amount originally established (line 3) and shows whether this latest estimate of claims cost is greater or less than originally thought. As data for individual policy years mature, the correlation between original estimates and reestimated amounts is commonly used to evaluate the accuracy of incurred claims currently recognized in less mature policy years. The columns of the table show data for successive policy years.

		Fiscal and Policy Year Ended (In Thousands of Dollars)									
		19W9	**19X0**	**19X1**	**19X2**	**19X3**	**19X4**	**19X5**	**19X6**	**19X7**	**19X8**
1.	Net earned required contribution and investment revenues	542	570	798	878	855	909	1,057	1,163	1,279	1,407
2.	Unallocated expenses	64	68	81	91	70	81	92	110	123	131
3.	Estimated incurred claims and expense, end of policy year	235	249	357	392	440	503	612	723	900	1,282

4. Paid (cumulative) as of:										
End of policy year	118	124	179	196	220	251	306	361	450	641
One year later	177	186	268	294	330	377	459	542	675	
Two years later	254	268	385	422	474	542	660	779		
Three years later	304	321	461	506	568	649	790			
Four years later	359	379	545	597	671	766				
Five years later	404	427	614	673	756					
Six years later	445	469	674	740						
Seven years later	473	499	717							
Eight years later	473	499								
Nine years later	473									
5. Reestimated incurred claims and expense:										
End of policy year	235	249	357	392	440	503	612	723	900	1,282
One year later	294	311	447	490	550	628	765	903	1,125	
Two years later	338	357	513	563	632	722	879	1,038		
Three years later	380	401	577	632	710	811	988			
Four years later	422	446	641	703	789	902				
Five years later	449	474	682	748	840					
Six years later	468	494	710	779						
Seven years later	473	499	717							
Eight years later	473	499								
Nine years later	473									
6. Increase (decrease) in estimated incurred claims and expense from end of policy year	238	250	360	387	400	399	376	315	225	0

Note: The following example illustrates only the disclosure required by paragraph 49a of this Statement:

Convenience Fund
Notes to Financial Statements
Fiscal Year Ended June 30, 19X8

A. Description of the Organization

The Convenience Fund (Fund) was formed in 19X2 under a joint powers agreement in accordance with Section 75 of the State of A Government Code. The agreement is to provide a cooperative program of group funding and risk management of property and casualty, workers' compensation, and employee health and medical claims for the employees of the Cities of X, Y, and Z. The Fund is not intended to function as an insurance company for the cities. Rather, it is a means of combining the administration of claims and of obtaining lower insurance rates. Although premiums billed to the cities are determined on an actuarial basis, ultimate liability for claims remains with the respective cities and, accordingly, the insurance risks are not transferred to the Fund.

Illustration 2: School District Participation in a Public Entity Risk Pool

Einstein School District
Notes to Financial Statements
Year Ended December 31, 19X8

G. Risk Management

The District is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. During January 19X8, the District was unable to obtain general liability insurance at a cost it considered to be economically justifiable. In February, the District joined together with other school districts in the State to form Schools Insurance Fund (SIF), a public entity risk pool currently operating as a common risk management and insurance program for 76 member school districts. The District pays an annual premium to SIF for its general insurance coverage. The Agreement for Formation of the SIF provides that SIF will be self-sustaining through member premiums and will reinsure through commercial companies for claims in excess of $10 million for each insured event.

The District continues to carry commercial insurance for all other risks of loss, including workers' compensation and employee health and accident insurance. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.

Illustration 3: City Government with Some Risk of Loss Retained

City of ABC
Notes to Financial Statements
Fiscal Year Ended June 30, 19X8

G. Risk Management

The City is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. During fiscal year 19X6, the City established a Risk Management Fund (an internal service fund) to account for and finance its uninsured risks of loss. Under this program, the Risk Management Fund provides coverage for up to a maximum of $250,000 for each worker's compensation claim, $125,000 for each general liability claim, and $10,000 for each property damage claim. In fiscal year 19X7, the Fund provided coverage of up to $50,000 for each worker's compensation claim and $25,000 for each general liability claim. The City purchases commercial insurance for claims in excess of coverage provided by the Fund and for all other risks of loss. Settled claims have not exceeded this commercial coverage in any of the past three fiscal years.

All funds of the City participate in the program and make payments to the Risk Management Fund based on actuarial estimates of the amounts needed to pay prior- and current-year claims and to establish a reserve for catastrophe losses. That reserve was $230,000 at June 30, 19X8 and is reported as a designation of the Risk Management Fund fund balance. The claims liability of $773,000 reported in the Fund at June 30, 19X8 is based on the requirements of Governmental Accounting Standards Board Statement No. 10, which requires that a liability for claims be reported if information prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. The City purchases annuity contracts from commercial insurers to satisfy certain liabilities under workers' compensation claims; accordingly, no liability is reported for those claims. At June 30, 19X8, $176,000 of those covered liabilities are still outstanding. Changes in the Fund's claims liability amount in fiscal 19X7 and 19X8 were:

	Beginning-of-Fiscal-Year Liability	**Current-Year Claims and Changes in Estimates**	**Claim Payments**	**Balance at Fiscal Year-End**
19X6–19X7	$675,000	$110,000	$(93,000)	$692,000
19X7–19X8	$692,000	$149,000	$(68,000)	$773,000

Illustration 4: State Government with All Risks of Loss Retained

State of ABC
Notes to Financial Statements
Fiscal Year Ended July 31, 19X8

G. Risk Management

It is the policy of the State not to purchase commercial insurance for the risks of losses to which it is exposed. Instead, the State management believes it is more economical to manage its risks internally and set aside assets for claim settlement in its internal service fund, the State Insurance Fund (SIF). SIF services all claims for risk of loss to which the State is exposed, including general liability, property and casualty, workers' compensation, employee health and accident, environmental, and antitrust. All funds, agencies, and authorities of the State participate in SIF. SIF allocates the cost of providing claims servicing and claims payment by charging a "premium" to each fund, agency, or public authority, based on a percentage of each organization's estimated current-year payroll. This charge considers recent trends in actual claims experience of the State as a whole and makes provision for catastrophe losses.

SIF liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported. Because actual claims liabilities depend on such complex factors as inflation, changes in legal doctrines, and damage awards, the process used in computing claims liability does not necessarily result in an exact amount. Claims liabilities are reevaluated periodically to take into consideration recently settled claims, the frequency of claims, and other economic and social factors. Liabilities for incurred losses to be settled by fixed or reasonably determinable payments over a long period of time are reported at their present value using expected future investment yield assumptions ranging from 6 to 9 percent. These liabilities are reported at their present value of $450,000 at July 31, 19X8.

The State and its component public authorities are defendants in a significant number of lawsuits pertaining to material matters. As of July 31, 19X8, claims outstanding against the State and its public authorities were $1.2 billion, for which the State estimates it will pay $7.5 million. Changes in the balances of claims liabilities during fiscal 19X7 and 19X8 were as follows:

	Beginning-of-Fiscal-Year Liability	Current-Year Claims and Changes in Estimates	Claim Payments	Balance at Fiscal Year-End
19X6–19X7	$5,537,000	$1,746,000	$(1,097,000)	$6,186,000
19X7–19X8	$6,186,000	$2,169,000	$ (868,000)	$7,487,000

At July 31, 19X8, SIF held $5.5 million in investments designated for payment of these claims. See Note C for additional information about these investments (not illustrated).

Illustration 5: City Government, All Risks Retained, Accounting in General Fund

City of ABC
Notes to Financial Statements
Fiscal Year Ended March 31, 19X7

G. Risk Management

The City is exposed to various risks of losses related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. Beginning in 19X5, the City decided to stop carrying commercial insurance because of its prohibitive cost and began covering all claim settlements and judgments out of its General Fund resources. The City currently reports all of its risk management activities in its General Fund. Claims expenditures and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. These losses include an estimate of claims that have been incurred but not reported.

At March 31, the amount of these liabilities was $1.123 million. This liability is the City's best estimate based on available information. Changes in the reported liability since March 31, 19X5 resulted from the following:

	Beginning-of-Fiscal-Year Liability	Current-Year Claims and Changes in Estimates	Claim Payments	Balance at Fiscal Year-End
19X5–19X6	$1,162,000	$290,000	$(405,000)	$1,047,000
19X6–19X7	$1,047,000	$314,000	$(238,000)	$1,123,000

Included in the $1.123 million are claims of $268,000, representing losses for which the lowest amount in a range of probable losses has been accrued because no amount within that range is a better estimate of loss. The City estimates that those losses could be as high as $395,000.

At March 30, 19X7, General Fund investments of $458,000 were held for purposes of funding the City's future claims liabilities. As a result, $458,000 of General Fund balance is designated for payment of future claims liabilities.

Appendix E

CODIFICATION INSTRUCTIONS

133. The sections that follow update the June 15, 1987 *Codification of Governmental Accounting and Financial Reporting Standards* for the effects of this Statement. Only the paragraph number of this Statement is listed if the paragraph will be cited in full in the Codification. (*Note:* Certain portions of these Codification instructions are incomplete due to the fact that guidance on display of claims liabilities reported by governmental funds will be provided in a future GASB Statement, as discussed in paragraphs 14 and 15 of this Statement. Codification instructions for that display will be provided in a future GASB pronouncement.)

*** * ***

LIABILITIES **SECTION 1500**

[Revise current Codification paragraph .110 as follows:]

Contingent Liabilities

.110 Contingent liabilities not requiring accrual should be disclosed in the notes to the financial statements in accordance with FASB Statement No. 5, *Accounting for Contingencies,* as outlined in Section C50, "Claims and Judgments," paragraph .115. This includes situations in which the governmental unit is contingently liable for proprietary fund or trust fund indebtedness. In the event that fund liabilities for which the unit is contingently liable are in default--or where for other reasons it appears probable that they will not be paid on a timely basis from the resources of these funds and default is imminent--these liabilities should be reported separately from other liabilities in the fund balance sheet. All significant facts with respect to the situation should be disclosed. [NCGAS 1, ¶46, as amended by GASBS 6, ¶13]

*** * ***

CLASSIFICATION AND TERMINOLOGY **SECTION 1800**

Sources: [Add the following:] GASB Statement 10

.103 [Delete footnote 1.]

.106b [Add item (5) as follows:]

(5) Transfers from governmental or proprietary fund types in excess of amounts calculated in accordance with Section C50, "Claims and Judgments," paragraph .125, to a risk-financing internal service fund. [GASBS 10, ¶68]

*** * ***

FINANCIAL REPORTING **SECTION 1900**

.105 [Delete footnote 1.]

*** * ***

COMPREHENSIVE ANNUAL FINANCIAL REPORT **SECTION 2200**

.123 [Delete footnote 8.]

*** * ***

NOTES TO FINANCIAL STATEMENTS **SECTION 2300**

.105 [Revise subparagraph a as follows:]

a. Entity risk management activities (See Section C50, "Claims and Judgments," paragraphs .134–.137.)

*** * ***

STATISTICAL TABLES **SECTION 2800**

Sources: [Add the following:] GASB Statement 10

[Add new paragraph .105 as follows:]

.105 Ten-year required supplementary information for public entity risk pools should be presented as statistical data in the oversight entity's CAFR in certain circumstances. See Section Po20, "Public Entity Risk Pools," paragraph .147. [GASBS 10, ¶50]

* * *

CLAIMS AND JUDGMENTS **SECTION C50**

[Revise entire section as follows:]

Sources: NCGA Statement 4
GASB Statement 10

Scope of This Section

.101 This section establishes accounting and financial reporting standards for **risk**[1] financing and **insurance**-related activities of state and local governmental entities other than **public entity risk pools**. Accounting and financial reporting by public entity risk pools is discussed in Section Po20, "Public Entity Risk Pools." Risks of loss from the following kinds of events are included within the scope of this section:

a. **Torts**.
b. Theft of, damage to, or destruction of assets.
c. Business interruption.
d. Errors or omissions.
e. Job-related illnesses or injuries to employees.
f. **Acts of God**.

The recognition and measurement requirements for these risks of loss are provided in paragraphs .109 through .128 of this section. [GASBS 10, ¶1]

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[1]Terms defined in paragraph .501 are printed in **boldface type** the first time they are used in this section. [GASBS 10, fn 1]

.102 [GASBS 10, ¶2] [Change “Statement” to “section.”]

.103 The recognition and measurement of liabilities that arise from breach of contract or similar actions, such as claims for delays or inadequate specifications on contracts or for guarantees of the indebtedness of others, property tax appeals, and unemployment compensation claims, are provided in paragraph .138. [GASBS 10, ¶3]

Background

.104–.107 [GASBS 10, ¶6–¶9]

Applicability of This Section

.108 The requirements of paragraphs .109 through .137 of this section apply to all state and local governmental entities, including public benefit corporations and authorities, public employee retirement systems, and governmental utilities, hospitals, colleges, and universities. [GASBS 10, ¶16]

Liability and Expenditure Recognition and Measurement—General Principles

.109–.120 [GASBS 10, ¶52–¶63] [Change “Statement” to “section” and change cross-references and footnote numbers.]

Risk Retention

.121–.125 [GASBS 10, ¶64–¶68] [Change cross-references.]

Entities Participating in Public Entity Risk Pools with Transfer or Pooling of Risk

.126–.127 [GASBS 10, ¶69 and ¶70] [Change cross-references.]

Entities Participating in Public Entity Risk Pools without Transfer or Pooling of Risk

.128 [GASBS 10, ¶71] [Change cross-references.]

Insurance-Related Transactions

.129–.132 [GASBS 10, ¶72–¶75] [Change cross-references.]

Entities Providing Claims Servicing or Insurance Coverage to Others

.133 [GASBS 10, ¶76] [Change cross-references and footnote numbers.]

Disclosures

.134–.137 [GASBS 10, ¶77–¶80] [Change cross-references and footnote numbers.]

Breaches of Contract and Other Claims

.138 State and local governments are subject to many types of claims. Subject to the accounting and financial reporting distinctions of governmental funds and expendable trust funds,[8] the criteria of FASB Statement 5, *Accounting for Contingencies*, should be the guidelines for recognizing a loss liability resulting from all claims that result from actions not included in the scope of paragraphs .109 through .137 of this section. (See paragraphs .101 and .102.) Those claims include contractual actions, such as claims for delays or inadequate specifications on contracts, or for guarantees of the indebtedness of others, property tax appeals, and unemployment compensation claims. A loss liability for these claims should be recognized when information available prior to issuance of the financial statements indicates it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. [NCGAS 4, ¶9 and ¶14, as amended by GASBS 10]

[8]However, liability for the tort of another assumed by contract by a governmental entity or a public entity risk pool on behalf of a participating entity *is* addressed in paragraphs .109–.137 of this section. For example, a local government may agree *by contract* to assume the liability for another jurisdiction's police officers in exchange for police services provided by that jurisdiction and not otherwise available to the governmental entity. [GASBS 10, fn 2]

Definitions

.501 [GASBS 10, Appendix B]

Nonauthoritative Discussion

Illustrative Disclosures

.601 [GASBS 10, Appendix D, Illustrations 2 through 5]

* * *

COLLEGES AND UNIVERSITIES **SECTION Co5**

Sources: [Revise as follows:] GASB Statements 2 through 10

.101 [Add the following:]

C50, "Claims and Judgments" [GASBS 2 through 7, GASBS 9 and 10, and GASBI 1]

* * *

HOSPITALS **SECTION Ho5**

Sources: [Add the following:] GASB Statement 10

.102 [Add the following:]

C50, "Claims and Judgments" [GASBS 2 through 7, GASBS 9 and 10, and GASBI 1]

* * *

[Add a new section Po20 as follows:]

PUBLIC ENTITY RISK POOLS **SECTION Po20**

Source: GASB Statement 10

Scope and Applicability of This Section

.101 The requirements of this section establish accounting and financial reporting standards for **risk**[1] financing and **insurance**-related activities of **public entity risk pools**. Accounting and financial reporting standards for state and local governmental entities other than risk pools are discussed in Section C50, "Claims and Judgments." [Change "Statement" to "section"; balance of paragraph not affected.] [GASBS 10, ¶1 and ¶16]

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[1]Terms defined in paragraph .501 are printed in **boldface type** the first time they are used in this section. [GASBS 10, fn 1]

.102 [GASBS 10, ¶2] [Change "Statement" to "section."]

Background

.103–.112 [GASBS 10, ¶4–¶13] [Change "Board" to "GASB" and change cross-references.]

Standards of Accounting and Financial Reporting

.113–.147 [GASBS 10, ¶17–¶51] [Change "Board" to "GASB" and change cross-references.]

Definitions

.501 [GASBS 10, Appendix B]

Nonauthoritative Discussion

Calculation of Pool Premium Deficiencies

.601 [GASBS 10, Appendix C] [Change "Statement" to "section" and change cross-references.]

Illustrative Disclosures

.602 [GASBS 10, Appendix D, Illustration 1]

* * *

PUBLIC BENEFIT CORPORATIONS AND AUTHORITIES SECTION Pu5

Sources: [Add the following:] GASB Statement 10

.101 [Add the following to the list in footnote 1:]

C50, "Claims and Judgments" Pu20, "Public Entity Risk Pools." [GASBS 2 through 7, GASBS 9 and 10, and GASBI 1]

* * *

Sources: [Add the following:] GASB Statement 10

.101 [Add the following to the list in footnote 1:]

C50, "Claims and Judgments" [GASBS 2 through 7, GASBS 9 and 10, and GASBI 1]