



INSURANCE SOLVENCY & COMPANY REGULATION DIVISION
Kirk Schmidt, Division Director

RE: Examination Report of Physicians Professional Indemnity Association
as of December 31, 2005

ORDER

After full consideration and review of the report of the financial examination of Physicians Professional Indemnity Association for the period ended December 31, 2005, together with any written submissions or rebuttals and any relevant portions of the examiner's workpapers, I, W. Dale Finke, Director, Missouri Department of Insurance, Financial Institutions and Professional Registration pursuant to section 374.205.3(3)(a), RSMo., adopt such report, with the following modifications or corrections:

- (1) Note 2 to the Notes to Financial Statement may be disregarded and instead the Director corrects such Note as follows: "Note 2: The amount reported by PPIA for Uncollected Premiums in the Course of Collection was increased by \$30,437 of premiums receivable improperly reported as being 90 days over due." As a result of this correction, the assets stated by the exam report should be increased by \$3,021,091;
- (2) The second paragraph of Note 5 to the Notes to Financial Statement may be disregarded and as a result the liabilities as stated by the exam report should be increased by \$3,221,398;
- (3) As a result of the modifications and corrections stated in paragraphs (1) and (2) above, in the Examination Changes, the "Total Examination Changes" is restated to (\$3,179,254) and the "Total Capital and Surplus Per Examination, December 31, 2005" is restated to (\$2,867,639);
- (4) The following statements are added prior to the last paragraph of Note 3 to the Financial Statements: "Expert Actuarial Services, LLC, did, however, conclude that 78% of the claims reported during 2005 would close without an indemnity payment, as a result of the spike in claims that occurred before legislative tort reform measures went into effect. This is a much higher percentage than would normally have

been used. Subsequent to the exam, the number of claims reported during 2006 has significantly decreased due to this 2005 spike;" and (5) the following statement is added at the end of the General Comments and/or Recommendations: "Assessments - The company is required by House Bill No. 1837 (Laws 2006), adopted after the as of date of the examination, to include within its articles or bylaws a method for assessing former members in the event of insolvency."

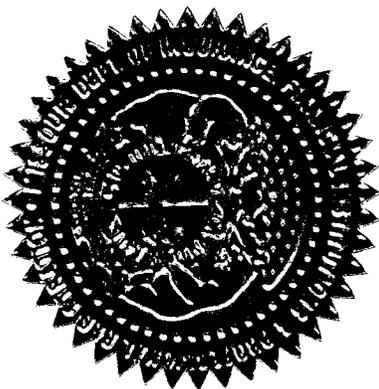
After my consideration and review of such report, workpapers, and written submissions or rebuttals, the examination report is incorporated by reference and deemed to be the Director's findings and conclusions to accompany this order pursuant to section 374.205.3(4), RSMo.

Based on such findings and conclusions, I hereby ORDER Physicians Professional Indemnity Association, to take the following action or actions, which I consider necessary to cure any violation of law, regulation or prior order of the Director revealed by such report: (1) implement, and verify compliance with each item mentioned in the General Comments and/or Recommendations section of such report; and (2) account for its financial condition and affairs in a manner consistent with the Director's findings and conclusions.

So ordered, signed and official seal affixed this 19 day of September, 2006.

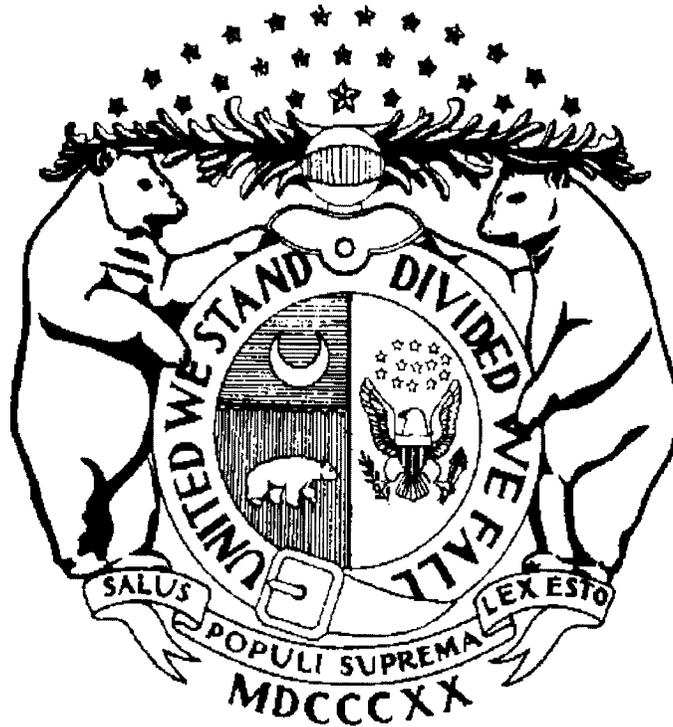


W. DALE FINKE, Director



**REPORT OF THE
ASSOCIATION FINANCIAL EXAMINATION OF
PHYSICIANS PROFESSIONAL INDEMNITY
ASSOCIATION**

**AS OF
DECEMBER 31, 2005**



**STATE OF MISSOURI
DEPARTMENT OF INSURANCE
JEFFERSON CITY, MISSOURI**

TABLE OF CONTENTS

<u>SUBJECT</u>	<u>PAGE</u>
SCOPE OF EXAMINATION	1
PERIOD COVERED.....	1
PROCEDURES.....	2
COMMENTS - PREVIOUS EXAMINATION.....	2
HISTORY	2
GENERAL.....	2
CAPITAL STOCK	2
DIVIDENDS	2
MANAGEMENT	3
COMMITTEES.....	3
OFFICERS.....	4
CONFLICT OF INTEREST	4
CORPORATE RECORDS.....	4
ACQUISITIONS, MERGERS AND MAJOR CORPORATE EVENTS	4
SURPLUS DEBENTURES.....	5
AFFILIATED COMPANIES	5
HOLDING COMPANY, SUBSIDIARIES AND AFFILIATES	5
FIDELITY BOND AND OTHER INSURANCE	5
PENSION, STOCK OWNERSHIP AND INSURANCE PLANS	5
STATUTORY DEPOSITS	6
DEPOSITS WITH THE STATE OF MISSOURI.....	6
INSURANCE PRODUCTS AND RELATED PRACTICES	6
GENERAL.....	6
ACQUISITION OF BUSINESS.....	6
PLAN OF OPERATIONS AND ADMINISTRATION.....	7

POLICY FORMS & UNDERWRITING 10

ADVERTISING & SALES MATERIALS..... 10

TREATMENT OF POLICYHOLDERS 10

REINSURANCE.....10

 GENERAL..... 10

 ASSUMED 10

 CEDED 10

ACCOUNTS AND RECORDS.....12

 GENERAL..... 12

FINANCIAL STATEMENTS12

 ASSETS 13

 LIABILITIES, SURPLUS AND OTHER FUNDS 13

 STATEMENT OF INCOME 14

 CAPITAL AND SURPLUS ACCOUNT 15

NOTES TO THE FINANCIAL STATEMENTS15

EXAMINATION CHANGES.....19

GENERAL COMMENTS AND/OR RECOMMENDATIONS.....20

SUBSEQUENT EVENTS21

ACKNOWLEDGMENT23

VERIFICATION23

SUPERVISION.....24

Kansas City, Missouri
June 30, 2006

Honorable Alfred W. Gross, Commissioner
Virginia Bureau of Insurance
Chairman of Financial Condition (EX4) Subcommittee
Southeastern Zone Secretary

Honorable Jorge Gomez, Commissioner
Wisconsin Department of Insurance
Midwestern Zone Secretary

Honorable W. Dale Finke, Director
Missouri Department of Insurance
301 West High Street, Room 530
Jefferson City, Missouri 65102-0690

Gentlemen:

In accordance with your financial examination warrant, a full scope association financial examination has been made of the records, affairs and financial condition of

Physicians Professional Indemnity Association

hereinafter referred to as such, as PPIA, or as the Association. Its administrative office is located at 101 West McCarty Street, Jefferson City, Missouri 65101, telephone number (573) 634-7742. This examination began on March 13, 2006, and concluded on the above date.

SCOPE OF EXAMINATION

Period Covered

This is the first financial examination of Physicians Professional Indemnity Association. This examination covers the period from when the Company was organized and commenced business in 2003 through December 31, 2005, and has been conducted by examiners from the State of Missouri, representing the Midwestern Zone of the National Association of Insurance Commissioners (NAIC), with no other zone participating.

This examination also included the material transactions and/or events occurring subsequent to the examination date, which are noted in this report.

Procedures

This examination was conducted using the guidelines set forth in the Financial Condition Examiners Handbook of the NAIC, except where practices, procedures and applicable regulations of the Missouri Department of Insurance (MDI) and statutes of the State of Missouri prevailed.

The examiners reviewed the prior year audit workpapers of the Association's independent auditor, Jamie L. Seaver, CPA, LLC, of Jefferson City, Missouri. Due to differences in timing (note that the fieldwork phase of this examination was completed before the Company's independent auditors began the 2005 audit), only minimal use was made of the work of the independent auditors.

Comments - Previous Examination

Since this is the first financial examination of PPIA, accordingly, there are no comments or notes from previous examination to review.

HISTORY

General

Physicians Professional Indemnity Association was incorporated on April 23, 2003, under Missouri law at Chapter 383 (Malpractice insurance). The Association was issued a Certificate Authority by the Missouri Department of Insurance on May 15, 2003, to operate as an assessable malpractice insurance corporation pursuant to the enabling law. In accordance with its Articles of Association, the Association is a not-for-profit corporation and operates as a mutual benefit corporation. PPIA is owned by the physician member-insureds.

Capital Stock

As a Missouri mutual assessment corporation, the Association is not required to maintain, and does not have capital stock. The method and process of assessments are documented in the Association's Articles of Association and Bylaws. However, there are no indications with respect to the assessment of ex-members, which may be necessary to address loss reserve and premium deficiencies that may have occurred during prior periods. Given that PPIA is an assessable corporation with no other sources of capital and surplus other than member assessments and earned surplus, the MDI believes that good business practice should compel the Association to add assessment of ex-members as a requirement of membership.

Dividends

The Association has not declared any dividends or made any cash dividend distributions since its incorporation.

Management

The management of PPIA is vested in a Board of Directors that is elected by its policyholders, who are also the members of the Association. The Association’s Bylaws specify that there shall be twelve (12) directors. The Board of Directors elected and serving, as of December 31, 2005, were as follows:

<u>Name</u>	<u>Address</u>	<u>Principal Occupation and Business Affiliation</u>
Carrie L. Carda, MD	Poplar Bluff, MO	Self Employed OB/GYN
Carl F. Patty, MD	Poplar Bluff, MO	Owner/Physician, Carl Patty MD, LLC
Patricia L. Cronin	Jefferson City, MO	Owner/Physician, Patricia L. Cronin MD, LLC
Benny E. Thomas, DO	Lake Ozark, MO	Self Employed Physician
John R. Patty, DO	Poplar Bluff, MO	John R. Patty DO, LLC
Robert L. Hall, MD	Poplar Bluff, MO	Owner/Surgeon, The Surgery Clinic of Poplar Bluff
Mark S. Vincent	Union, MO	Attorney, Vincent, Haven & Purschke, P.C.
Robert C. Young, MD	Poplar Bluff, MO	Self Employed Medical Practitioner
Warren K. Miller, CPA	Millersville, MO	Administrator, Cape Radiology Group

Contrary to the stipulations in the Articles of Association and Bylaws which calls for a Board of Directors consisting of twelve (12) members, the Association has only nine (9) members elected to its Board of Directors. The Association is directed to elect more members to its Board of Directors or amend the Articles of Association and the Bylaws to require a minimum of nine (9) members.

Committees

The Bylaws empower the Board of Directors to establish one or more committees, each composed of three (3) or more members of the Board. As of December 31, 2005, the following committees have been established with following individuals serving:

Executive Committee

- Carrie L. Carda, MD, Chairman
- Robert C. Young, MD
- Carl F. Patty, MD

Claims and Settlement Committee

- Benny E. Thomas, MD, Chairman
- Mark S. Vincent
- Robert C. Young, MD
- Robert L. Hall, MD
- Carrie L. Carda, MD
- Jonathan L. Downard
- Lloyd R. Downard

Officers

The officers of the Association elected and serving as December 31, 2005, were as follows:

Robert C. Young, MD	President
Jonathan L. Downard	Executive Vice President
Robert L. Hall, MD	Secretary
Carl F. Patty, MD	Treasurer

Conflict of Interest

The Association has procedures for the disclosure of any conflicts of interest that may exist. However, the procedure does not require annual disclosure and signatory, as such, the Association's officers and directors only signed the conflict of interest statement at the time of election or appointment. This practice is not sufficient since an individual officer or director's status and business relationships could change. The Association is directed to have its officers and directors sign its conflict of interest statement annually.

Corporate Records

The Association's Articles of Association and Bylaws were reviewed for the period under examination. The original Articles of Association was amended and restated effective September 17, 2004, to: (a) amend Article VII to limit the maximum amount of any one regular or special Assessment against a member to be twenty-five percent (25%) of a member's annual premium; (b) amend Article IX to require that all physicians elected to the Board of Directors must be members of the Association; (c) amend Article XIII to stipulate that the Association is established as a not-for-profit corporation; (d) amend Article XIV to stipulate that the Association shall have members and (e) amend Article XV to prescribe the basis of the distribution of the Association's assets in the event of dissolution.

The Bylaws of the Association was amended pursuant to the action of the Board of Directors of August 21, 2004, to change the Annual membership and Board of Directors' meeting date to the third Saturday in August.

The minutes of the Board of Director's meetings, the Committee meetings and the members' annual meetings were reviewed for proper approval of corporate transactions. The minutes, in general, appear to properly reflect and approve the Association's major transactions and events for the period under examination.

Acquisitions, Mergers and Major Corporate Events

None during the examination period.

Surplus Debentures

None.

AFFILIATED COMPANIES

Holding Company, Subsidiaries and Affiliates

Physicians Professional Indemnity Association was organized under Missouri Law at Chapter 383 (Malpractice insurance). Entities organized under Chapter 383 are not subject to the Insurance Holding Companies Law under Section 382, Revised Statutes of Missouri. Consequently, PPIA is not deemed to be a member of an insurance holding company, as such, the Association is not required to file or disclose its holding company structure, if any.

FIDELITY BOND AND OTHER INSURANCE

Physicians Professional Indemnity Association is the primary insured on a business insurance coverage offering an employee dishonesty endorsement with a limit of \$50,000. Per NAIC guidelines, the Association is required to carry a minimum fidelity bond policy with a liability limit of \$150,000. The Association is directed to increase its fidelity bond coverage to a minimum liability limit of \$150,000.

The Association is also covered by the following business insurance coverages: Business Property, Business Liability and General Aggregate (Umbrella) insurance.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The business operations of Physicians Professional Indemnity Association have been out-sourced to independent contractors who are not employees of the Association. The consideration for the various services, including accounting, actuarial, legal, underwriting, etc., did not include any provisions for pensions or benefits. The Association has one full-time office staff, and part-time officers who are paid salaries, however, there are no pensions or benefits associated with the salaries of these employees.

STATUTORY DEPOSITS

Deposits with the State of Missouri

Pursuant to the applicable laws, the Association is not required to deposit funds for the benefits of policyholders, as is customary with other insurers organized under different Missouri insurance laws. Consequently, the Association did not have any funds on deposit with the State of Missouri as of December 31, 2005.

INSURANCE PRODUCTS AND RELATED PRACTICES

General

Physicians Professional Indemnity Association is incorporated under Missouri law at Chapter 383 (Malpractice insurance). The Association was issued a Certificate of Authority by the Missouri Department of Insurance on May 15, 2003, to operate as an assessable malpractice insurance corporation pursuant to the enabling law. The Association is only licensed in the State of Missouri. However, by way of endorsement #4 to the underlying insurance policy form, insured physicians who provide health care services in the State of Kansas may be covered by a policy, however, such coverage may be limited with regard to policy limits, etc.

As was noted elsewhere in this report, PPIA is primarily owned by the member-insureds, who are licensed physicians. The members elect a Board of Directors, who has the ultimate responsibility to manage the property and affairs of the Association. PPIA writes one line of business, medical malpractice insurance, on a claims-made basis with policy limits of \$1 million in the State of Missouri. A three-year retroactive coverage with a maximum limit of \$500,000 is also available. PPIA's target market is physicians that provide medical services in the entire State of Missouri. The Association offers membership to physicians who are independent practitioners and/or independent groups without any regard to size of operation. PPIA's current membership is composed of 680 member-insureds, comprising of 460 rural practitioners and 220 practitioners in metropolitan areas. The Association has a twenty percent (20%) growth target in membership for 2006, with an overall business plan of achieving total membership of 2,500 members within the next five years.

Acquisition of Business

The Association utilizes the services of three independent agencies to obtain business, with Missouri State Medical Association Insurance Agency, Inc. (MSMA) being the primary and lead producer. The agencies are paid commissions based on premiums at variable rates between first year and renewal premiums. The Association's future acquisition goal is to build on its relationship with MSMA and cultivate relationships with other professional associations and independent physician organizations to generate membership growth.

Plan of Operations and Administration

The day-to-day operations of the Association have been out-sourced to independent contractors for agreed upon considerations for the services provided. As of December 31, 2005, the Association has entered into the following agreements for the provision of various administrative and insurance operations services:

1. **Type:** Administration Agreement
- Parties:** Corporate Insurance Services, LLC (CIS)
- Effective:** July 30, 2003, and restated effective May 26, 2005, without any substantive change in functions and considerations.
- Terms:** Subject to the control and approval of the Association's Board of Directors, CIS functions as the insurance administrator of PPIA and provided the administrative services to form the Association. The agreement obligates CIS to provide business management, administrative, investment, underwriting, policy administration and issuance, insurance regulatory compliance, coordination of actuarial, accounting and auditing services and such other duties that are customarily performed by an administrative service provider as the Board of Directors may assign. CIS is responsible for providing day-to-day consultation on management, financial, personnel, policy decisions, underwriting, investment of funds, payment of claims and regulatory compliance. As consideration for the services provided, CIS is to receive ten percent (10%) of the first three million dollars (\$3 million) of gross premium, eight percent (8%) of the next two million dollars (\$2 million) of gross premium and six percent (6%) of any additional premiums over five million dollars (\$5 million).

PPIA has paid CIS \$668,064, \$360,786 and \$13,429 for the years 2005, 2004 and 2003, respectively.

2. **Type:** Legal Services Agreement
- Parties:** Hansen, Stierberger, Downard, Melebrink & Schroeder (the Firm)
- Effective:** Originally entered into effective June 1, 2003, with Jonathan Downard, as an individual attorney. Agreement was restated effective May 26, 2005, to change the identity of the service provider without any substantive change in the manner or character of services provided.
- Terms:** The Firm provides legal services, representations and legal consulting to PPIA's Board of Directors and management. The Firm is responsible for providing legal advice to ensure regulatory compliance and legal consultation on the day-to-day operations of the Association. The Firm is compensated five thousand dollars (\$5,000) per month for providing these legal services.

PPIA has paid the Firm \$60,000, \$35,000 and \$0 for the years 2005, 2004 and 2003, respectively.

3. Type: Office Lease Agreement

Parties: U.S. Bank, National Association (Landlord)

Effective: July 1, 2005

Terms: The Association rented approximately 1,095 square feet of space, located on the second floor of the U.S. Bank building in Jefferson City, Missouri. The lease is for a term of five (5) years, at a monthly rent of \$960.00.

PPIA has paid the Landlord \$6,720, \$5,400 and \$0 for the years 2005, 2004 and 2003, respectively.

4. Type: Agency Agreement

Parties: Missouri State Medical Association Insurance Agency, Inc. (MSMA)

Effective: Originally entered into effective August 14, 2003. Article II of the agreement was amended effective August 30, 2003, to recognize MSMA as the lead agency with a two percent (2%) over-write commission on policies written by other agencies and to increase its renewal commission rate from eight percent (8%) to ten percent (10%).

Terms: The agreement authorizes MSMA to solicit applications for new business on behalf of PPIA and to service insurance policies issued by PPIA. For these services, MSMA is to be paid a first year and renewal commission rate of ten percent (10%) of the premiums collected on each issued policy. The agreement was amended to recognize MSMA as the lead agency for the Association resulting in an over-write commission of two percent (2%) on collected premiums written by other agencies.

PPIA has paid MSMA \$726,135, \$379,024 and \$44,350 for the years 2005, 2004 and 2003, respectively.

Exception: The amended agreement, which recognized MSMA as the lead agency with the two percent (2%) over-write commission is vague with respect to the functions and responsibilities of MSMA for earning this extra commission. The amended agreement should be revised to specifically state what functions MSMA must perform as the lead agency of the Association, which should justify the two (2%) over-write commission.

The Association is hereby directed to revise the amendment to the MSMA agreement by specifying what functions MSMA must perform in order to earn the two percent (2%) over-write commission.

5. Type: Agency Agreement

Parties: Cretcher-Lynch & Company (Cretcher-Lynch)

Effective: Originally entered into effective July 1, 2003. Article II of the agreement was amended effective October 1, 2004, to increase the commission rates to ten percent (10%).

Terms: The agreement authorizes Cretcher-Lynch to solicit applications for new business on behalf of PPIA and to service insurance policies issued by PPIA. For these services provided, Cretcher-Lynch is to be paid a first year and renewal commission rate of ten percent (10%) of the premiums collected on each issued policy.

PPIA has paid Cretcher-Lynch \$95,545, \$68,290 and \$24,904 for the years 2005, 2004 and 2003, respectively.

6. Type: Agency Agreement

Parties: Administrative Management Corporation d/b/a MedPro (MedPro)

Effective: Originally entered into effective July 1, 2003. Article II of the agreement was amended effective September 11, 2003, to change the commission rates from eight percent (8%) to five percent (5%).

Terms: The agreement authorizes MedPro to solicit applications for new business on behalf of PPIA and to service insurance policies issued by PPIA. For these services, MedPro is to be paid a first year and renewal commission rate of five percent (5%) of the premiums collected on each issued policy.

PPIA has paid MedPro \$0, \$31,693 and \$6,896 for the years 2005, 2004 and 2003, respectively.

Overall: For each of the agreements summarized above, the Association should summarize the nature of, and disclose the amounts paid, under each of the agreements. PPIA is therefore, directed to report the yearly amounts paid to each party to the agreements in the Notes to the Financial Statement section of the Annual Statement under “Information Concerning Parent, Subsidiaries and Affiliates” section.

In addition to the above agreements, the Association utilizes the services of a local accounting firm for accounting and Chief Financial Officer function, an actuarial firm for loss reserve certification, a different actuarial firm for rate making and an investment management firm for investment advisory services. The Association has also appointed various law firms, representing certain regions of the State of Missouri, as claims defense attorneys, to represent the interest of insured-policyholders in lawsuits arising from the insured risks.

Policy Forms & Underwriting
Advertising & Sales Materials
Treatment of Policyholders

The Missouri Department of Insurance has a market conduct staff that performs a review of these issues and generates a separate market conduct report. However, the MDI did not conduct any market conduct examinations of the Association during the examination period. A cursory review of these issues during this examination did not uncover any material problems.

REINSURANCE

General

The Association's premium activity on a direct written, assumed and ceded basis, for the period under examination, is detailed below:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Direct Business	\$8,466,959	\$8,102,880	\$938,833
Reinsurance Assumed			
Reinsurance Ceded:			
Affiliates			
Non-affiliates	(2,475,000)	(0)	(0)
Net Premiums Written	<u>\$5,991,959</u>	<u>\$8,102,880</u>	<u>\$938,833</u>

Assumed

The Association does not assume any business.

Ceded

The Association is contingently liable for all reinsurance losses ceded to others. This contingent liability would become an actual liability in the event that an assuming reinsurer fails to perform its obligations under the reinsurance agreement.

Physicians Professional Indemnity Association has one excess of loss reinsurance agreement with subscribing Reinsurers at Lloyds (Reinsurers), consisting of five individual syndicates. The agreement was entered into effective April 1, 2005, for three successive one year periods. Pursuant to the terms of the agreement, PPIA cedes any claims over \$500,000 per individual claim to the reinsurers, with PPIA retaining all amounts under \$500,000 per individual claim. The agreement established the maximum policy limit at \$1 million each claim or \$3 million annual aggregate. The agreement further established that the ultimate net sum payable by the

Reinsurer shall not exceed 200% of the adjusted premium paid by PPIA or \$13.2 million during the first agreement annual period.

The subscribing Reinsurers at Lloyds who are participants to this agreement and their levels of participation are as follows:

➤	Max Re	29.6296%
➤	Aspen Re	22.2223%
➤	AML	18.5185%
➤	HAR	14.8148%
➤	SAM	14.8148%
Total		<u>100.00%</u>

For the reinsurance coverage provided, the agreement requires PPIA to pay an annual deposit premium of the greater of \$3.3 million or 27.5% of the Gross Net Written Premium. As of December 31, 2005, PPIA has paid approximately \$2.5 million in premium, covering the last three quarters of 2005.

Effective April 1, 2006, PPIA and the subscribing Reinsurers at Lloyds ended the excess of loss reinsurance agreement on a going-forward-basis. PPIA replaced the aforementioned agreement with another excess of loss reinsurance agreement with PIPCO SPC, (Physicians Insuring Physicians Company) a Cayman Islands reinsurer, effective April 1, 2006. This agreement is retroactive to all claims filed on or after April 1, 2006, on policies issued since May 15, 2003. Pursuant to the terms of the agreement, PPIA cedes any claims over \$500,000 per individual claim to the reinsurers, with PPIA retaining all amounts under \$500,000 per individual claim. The agreement further established that the ultimate net sum payable by the reinsurer shall not exceed 150% of the adjusted premium paid by PPIA.

The agreement with PIPCO SPC further requires the reinsurer to establish a trust agreement, which shall contain the premiums paid by PPIA or in the alternative; the reinsurer shall maintain a trust account for which PPIA is the beneficiary in the amount of \$1 million.

Due to lack of familiarity with the operations of PIPCO SPC and its newness in the reinsurance market, the MDI performed additional reviews to understand the management and operations of PIPCO SPC and how PPIA could be impacted. See the Subsequent Event section of this report for more details.

ACCOUNTS AND RECORDS

General

The CPA firm, Jamie L. Seaver, CPA, LLC, of Jefferson City, Missouri, issued audited statutory financial statements of the Association for the first two years [2003 and 2004] of the examination period. The 2005 audit was not yet completed as of the last day of the current examination fieldwork.

Policy and claim reserves were reviewed and certified by Steven J. Regnier, ACAS, MAAA, FCA with Regnier Consulting Group, Inc., of Stevens Point, Wisconsin.

FINANCIAL STATEMENTS

The following financial statements, with supporting exhibits, present the financial condition of Physicians Professional Indemnity Association for the period ending December 31, 2005. Any examination adjustments to the amounts reported in the financial statements and/or comments regarding such are made in the “Notes to the Financial Statements.” The failure of any column of numbers to add to its respective total is due to rounding or truncation.

There may have been additional differences found in the course of this examination, which are not shown in the “Notes to the Financial Statements.” These differences were determined to be immaterial concerning their effect on the financial statements, and therefore were only communicated to the Company and noted in the workpapers for each individual Annual Statement item.

Assets

	<u>Assets</u>	Nonadmitted <u>Assets</u>	Net Admitted <u>Assets</u>
Bonds	\$4,716,377		\$4,716,377
Cash and Short-term Investments Note 1	1,573,862		1,573,862
Common Stocks Note 1	1,125,728		1,125,728
Investment Income Due and Accrued	57,881		57,881
Uncollected Premiums and Agents' Balances Note 2	149,897		149,897
Federal Income Tax Recoverable	271,984		271,984
Net Deferred Tax Asset	480,988		480,988
EDP Equipment	6,323	\$6,323	0
Furniture and Equipment	12,220	12,220	0
Aggregate Write-ins for Other Assets	<u>7,971</u>	<u>7,971</u>	<u>0</u>
TOTAL ASSETS	<u>\$8,403,231</u>	<u>\$26,514</u>	<u>\$8,376,717</u>

Liabilities, Surplus and Other Funds

Losses Note 3	\$6,594,000
Loss Adjustment Expenses Note 3	2,326,000
Commissions Payable Note 4	42,158
Other Expenses	4,306
Taxes, Licenses and Fees	2,928
Unearned Premiums Note 5	896,238
Advance Premium Payable for Securities	425,608
	726,489
Aggregate Write-Ins for Liabilities:	
Unearned Finance Charges Note 6	<u>26,322</u>
TOTAL LIABILITIES	\$11,044,049
Unassigned Funds (Surplus) Note 7	(\$2,667,332)
TOTAL LIABILITIES AND SURPLUS	<u>\$8,376,717</u>

Statement of Income

UNDERWRITING INCOME

Premiums Earned	\$6,187,650
Losses Incurred	4,010,158
Loss Expenses Incurred	1,379,053
Other Underwriting Expenses Incurred	<u>1,628,001</u>
Total Underwriting Deductions	<u>\$7,017,212</u>
Net Underwriting Gain/(Loss)	<u>(\$829,562)</u>

INVESTMENT INCOME

Net Investment Income Earned	145,900
Net Realized Capital Gains or (Losses)	<u>(18,788)</u>
Net Investment Gain or (Loss)	<u>\$127,112</u>

OTHER INCOME

Finance and Service Charges not Included in Premiums	312,592
Miscellaneous Other Income	<u>4</u>
Total Other Income	<u>\$312,596</u>
Net income before dividends to policyholders and federal income taxes	(\$389,854)
Federal and foreign income taxes incurred	<u>(160,463)</u>
Net Income	<u>(\$229,391)</u>

Capital and Surplus Account

Surplus as Regards Policyholders, December 31, 2004	\$599,957
Net Income	(229,391)
Change in Non-admitted Assets	(56,951)
Capital Changes:	
Transferred from Capital (Return of Capital)	(2,000)
Examination Change	<u>(2,978,947)</u>
Net Change in Surplus as Regards Policyholders for the Year	<u>(\$3,267,289)</u>
Surplus as Regards Policyholders, December 31, 2005	<u>(\$2,667,332)</u>

Notes to the Financial Statements

Note 1 – Cash and Short-term Investments	\$1,573,862
Common Stocks	\$1,125,728

The amount reported by the Association for Cash and Short-term Investments was reduced by \$1,125,728 and the amount reported by the Association for Common Stocks was increased from \$0 to \$1,125,728. This reclassification was made to correct the erroneous presentation of the Association's investment in a Charles Schwab and Company money market fund that was not listed on the exempt list. According NAIC guidelines, money market funds that are not listed in the exempt list as maintained by the Securities Valuation Office of the NAIC must be reported as common stocks on the Annual Statements. PPIA is directed to abide by this reporting standard in the future.

Note 2 – Uncollected Premiums in the Course of Collection	\$149,897
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The amount reported by PPIA for Uncollected Premiums in Course of Collection was reduced by \$3,021,091, consisting of \$3,051,528 of overstated premiums receivable and a reinstatement of \$30,437 of premiums receivable improperly reported as being 90 days over due. PPIA overstated the balance in this account as of December 31, 2005, by reporting as due and receivable, premiums that were not yet billed and not yet due from the policyholders. This practice resulted in this account being overstated by \$3,021,091 as of the examination date. The Association incorrectly recorded the annualized policy premium, although the policyholders, in majority of the cases, only paid on installment basis (monthly, quarterly, etc.). The examination obtained the underlying premium database and recalculated uncollected premium balance in accordance with statutory guidelines and the NAIC's Annual Statement Instructions. PPIA is directed to properly and accurately report its uncollected premium account by

recognizing only billed but uncollected premiums in this account. Simply stated, only billed policies, which are currently active, and that remains uncollected at the end of the quarter or at year-end, should be reported as uncollected.

Note 3 – Losses	\$6,594,000
Note 3 – Loss Adjustment Expenses	\$2,326,000

The MDI engaged Expert Actuarial Services, LLC (EAS) to perform an actuarial review of the loss and loss adjustment expense reserves of PPIA. EAS issued an actuarial opinion and report to the MDI and determined that PPIA's reported loss and LAE reserves of \$6,001,820, as of December 31, 2005, were deficient by \$2,918,180 on a net-of-reinsurance basis. An examination change was made to increase Loss and LAE reserves by the indicated deficiency. This amount consists of the following components:

<u>Description</u>	<u>Deficiency</u>
Using Gross-of-Reinsurance Benchmarks*	\$200,000
Case Reserves Deficiency Recognition**	1,818,180
Additional Projection Methods***	200,000
LAE Ratio Applied to Report Year 2004****	500,000
Other*****	<u>200,000</u>
Total Reserve Deficiency	<u>\$2,918,180</u>

- *In this category, EAS adjusted the reserves to account for the fact that PPIA did not enter into any reinsurance arrangement until 2005. On this basis, EAS noted that most of the experience period evaluated as part of the reserve analysis involved uncapped claims – whether examined gross of reinsurance or net of reinsurance, since there was essentially no reinsurance during the period under examination. EAS opined that the benchmark data used to project PPIA's losses should have been based on gross-of-reinsurance data, which typically yields higher development factors and consequently, higher indicated reserves.
- **Additional reserve was indicated following an independent study of the Association's claims and carried case reserve levels. The study was necessitated by the newness of PPIA and the relatively sparse amount of historical data available as a result of the relatively brief period of insurance operations. [Other detailed recommendations emanating from the study have been communicated to the Association's management]. The study concluded that the Association's case reserves are materially below levels suggested based on the facts in the individual claim files reviewed. The actuarial study's reliance on industry-based development factors involved the assumption that the Association's case reserves were generally at industry levels. Since the claim study found that this assumption was invalid, adjustments were required in the actuarial analysis which led to higher indicated reserves.
- *** The impact of other applicable methods of reserve evaluation was recognized by EAS in its analysis. This is predicated on a proposed actuarial standard of practice that

requires the recognition of the impact of multiple applicable methods, unless in the actuary's professional opinion, a particular method is clearly superior to other methods.

- ****The Association's opining actuary reduced the reserves for Loss Adjustment Expense reserves by an undocumented \$500,000. This adjustment was reversed by EAS as the seemingly underlying justification was not defined.
- *****EAS' analysis involved estimating an overall indicated reserve deficiency (estimated at \$2.9 million net-of-reinsurance) which is based on the combined impact of all of the above described elements. The individual component estimates were rough quantifications since the components are not independent of each other. The impact for the individual components makes up \$2.7 million of the total \$2.9 million net reserve deficiency. Thus, EAS attributes the final \$200,000 difference to "Other" with such just serving to produce the correct bottom-line total estimated deficiency.

In each of the categories described above, PPIA is directed to work with its in-house actuary to develop and implement procedures that would address the underlying issues identified, which ultimately should result in adequate reserve levels.

Loss Reserve Discounting

In accordance with Sections 383.035(9) and 379.102 RSMo, it appears that the Association could discount its loss reserve liabilities. Generally, discounting provides a reduction to current loss liabilities for the anticipated future revenues to be made from the investment of premiums for long tail lines of business. When applying an interest rate of 2.5% this discount would be approximately \$406,000 when applied to the indicated net reserve liability in this examination in the amount of \$6,594,000.

Note 4 - Commissions Payable

\$42,158

The amount reported by the Association for the above referenced liability is \$31,198 more than the amount calculated and reported by the examination as of December 31, 2005. The amount reported by the Association on the 2005 Annual Statement, (\$73,356), represents the amount of commissions due to agents during the period of January 1 through 15, 2006. These commissions were not due and payable to the agents as of December 31, 2005, based on the agency agreement terms and therefore, should not have been included in the Commission Payable liability. The Association subsequently provided detail records for commissions due to agents, which totaled \$42,158. Therefore, an examination adjustment of \$31,198 has been made to restate the 2005 Annual Statement balance for this account. The Association is directed to ensure that only commissions due to agents, which remain unpaid as of year-end or quarter-end are reported on the Commissions Payable line of the Annual or Quarterly Statements.

Note 5 – Unearned Premiums**\$896,238**

The amount reported by the Association for the above referenced liability is \$2,781,272 more than the amount calculated and reported by the examination as of December 31, 2005. This overstatement resulted from two errors made by the Association as follows:

First, the Association calculated its Gross Unearned Premium on all written policies by improperly annualizing the premiums. This resulted in the Association recording Gross Unearned Premium for installments for which premiums had not been received or due as of December 31, 2005. This practice overstated the Association's Gross Unearned Premium liability on the Annual Statement. After this erroneous reporting was presented to the Association, PPIA recalculated the unearned premium using logical and correct procedures, which resulted in Gross Unearned Premium of \$1,236,190, a far departure from the initial balance of \$4,457,588.

Second, the Association has a reinsurance contract that allows for the ceding of 27.5% of Gross Written Premium. However, when the Association calculated its Ceded Unearned Premiums, an arbitrary cession rate of 17.5% was used. The examination recalculated the Ceded Unearned Premium reserve, using the correct ceding rate, which resulted in a corrected Ceded Unearned Premium of \$339,952, compared to the incorrect balance of \$780,078 reported by PPIA.

The net effect of these adjustments resulted in Net Unearned Premium of \$896,238 as of December 31, 2005. In the future, the Association is directed to only record Gross Unearned Premiums on those policies whose premiums have actually been received. The Association is also directed to calculate its Ceded Unearned Premium using the cession rate that is used to calculate actual ceding premiums paid to the reinsurer as established in the reinsurance agreement.

Note 6 – Unearned Finance Charges**\$26,322**

The amount reported by PPIA for this liability account was overstated by \$147,854 as of December 31, 2005. The Association was annualizing policy finance charge amounts and incorrectly recording liabilities for finance charges that had not been received. After reviewing the detail records for the collected finance charges at December 31, 2005, an adjustment was made to the account balance to reduce the Aggregate Write-In Liability for Unearned Finance Charges from \$174,176 to \$26,322. The Association is directed to ensure that only those finance charges that have been received and are unearned as of quarter-end or year-end are reported as Unearned Finance Charges.

Note 7 – Unassigned Fund (Surplus)**(\$2,649,152)**

At December 31, 2005, the Association's surplus was less than zero, with an examination adjusted surplus of (\$2,649,152). It is recommended that the association take necessary steps to restore its surplus to zero or greater.

Examination Changes

Capital and Surplus Per the Association, December 31, 2005:

Common Stock	\$0
Unassigned Funds	<u>311,615</u>
Total Capital and Surplus Per Association	\$311,615

Examination Changes*

Decrease Uncollected Premiums in Course of Collection Note 2	(\$3,021,091)
Increase Loss Reserves Note 3	(1,664,000)
Increase Loss Adjustment Expense Reserves Note 3	(1,254,180)
Decrease Commissions Payable Note 4	31,198
Decrease Unearned Premiums Note 5	2,781,272
Decrease Unearned Finance Charges Note 6	<u>147,854</u>
Total Examination Changes	(\$2,978,947)

Capital and Surplus Per Examination, December 31, 2005:

Common Stock	\$0
Unassigned Funds	<u>(\$2,667,332)</u>
Total Capital and Surplus Per Examination, December 31, 2005	<u>(\$2,667,332)</u>

* Does not include reclassification changes, which have zero net effect on capital and surplus.

General Comments and/or Recommendations

Capital Stock (page 2)

Since PPIA is an assessable corporation with no other sources of capital and surplus other than member assessments and earned surplus, the MDI believes that good business practice should dictate that the Association assess ex-members and establish this as a requirement for membership. Such assessment should only be made when needed to shore up its capital and surplus and recover loss reserve and premium deficiencies that may have occurred during prior periods. The MDI strongly recommends that PPIA implement this recommendation.

Management (page 3)

The Association had nine (9) members on its Board of Directors as of December 31, 2005, contrary to its Articles of Association and Bylaws, which stipulates for a minimum of twelve (12) members. The Association is directed to elect more members to its Board of Directors or amend the Articles of Association and the Bylaws to require a minimum of nine (9) members.

Conflict of Interest (page 4)

The Association's conflict of interest disclosure statement does not require that officers and directors complete and sign the statement annually. Accordingly, review of the signed conflict of interest statements showed a pattern of officers and directors signing the statements once upon election and/or appointment. This practice is not sufficient since an individual officer or director's status and business relationships could change. The Association is directed to have its officers and directors sign its conflict of interest statement annually.

Fidelity Bond and Other Insurance (page 5)

Physicians Professional Indemnity Association is the primary insured on a business insurance coverage offering an employee dishonesty endorsement with a limit of \$50,000. Per NAIC guidelines, the Association is required to carry a minimum fidelity bond policy with a liability limit of \$150,000. The Association is directed to increase its fidelity bond coverage to a minimum liability limit of \$150,000.

Agreement with MSMA (page 8)

The amended agreement with Missouri State Medical Association Insurance Agency, Inc., (MSMA) should be revised to specifically state what functions MSMA must perform as the lead agency of the Association, which should justify the two (2%) over-write commission. The Association is hereby directed to revise the amendment to the MSMA agreement by specifying what functions MSMA must perform in order to earn the extra two percent (2%) over-write commission.

Overall – Agreements with Third Parties (page 9)

For each of the agreements with third parties, PPIA is directed to report the yearly amounts paid to each party in the “Notes to the Financial Statement” section of the Annual Statement under “Information Concerning Parent, Subsidiaries and Affiliates” section.

Notes to the Financial Statement (pages 15 through 18)

This examination uncovered numerous instances where the Association improperly reported, valued and/or classified items on the Annual Statement. These exceptions are documented on seven (7) separate notes on pages 15 through 18 under the “Notes to the Financial Statements” section of this report. Each of these notes directs PPIA to prepare the Annual Statement in accordance with NAIC’s Annual Statements Instructions and the applicable NAIC’s Statements of Statutory Accounting Principles. The Association is hereby directed to implement these directives and ensure that its future Annual Statement is prepared in accordance with the applicable standards and procedures.

Subsequent Event (pages 21 through 22)

The reinsurance arrangement with Physicians Insuring Physicians Company (PIPICO SPC) is deemed to constitute a related party transaction lacking in the structures and benefits of an arms length transaction and appears to be preferential to certain policyholders of PPIA. It was also noted by the MDI that PIPICO SPC is not an admitted carrier in Missouri. PPIA should be aware that reserve credits are not allowed on cessions to unauthorized carriers, such as PICO SPC unless adequate security is provided that is acceptable to the MDI.

PPIA should disclose the related party nature of the agreement and all other related features in future Annual Statements and also continue to evaluate the relationships under the agreement to be certain that it is beneficial for the entire membership of the Association.

PPIA should also ensure that an adequate security, acceptable to the MDI, is in place before reserve credits for cessions to PIPICO SPC are reported on the Annual Statement or Quarterly Statements.

SUBSEQUENT EVENTS**Reinsurance**

Effective April 1, 2006, PPIA ended its excess of loss reinsurance agreement with named Reinsurers at Lloyds of London on a going-forward-basis. PPIA replaced the agreement with the Reinsurers at Lloyds with another excess of loss reinsurance agreement with PIPICO SPC, (Physicians Insuring Physicians Company) a Cayman Islands reinsurer, effective April 1, 2006. This agreement is retroactive to all claims filed on or after April 1, 2006, on policies issued since

May 15, 2003. Pursuant to the terms of the agreement, PPIA cedes any claims over \$500,000 per individual claim to the reinsurers, with PPIA retaining all amounts under \$500,000 per individual claim. The agreement further established that the ultimate net sum payable by the reinsurer shall not exceed 150% of the adjusted premium paid by PPIA.

The agreement with PIPCO SPC further requires the reinsurer to establish a trust agreement, which shall contain the premiums paid by PPIA or in the alternative; the reinsurer shall maintain a trust account for which PPIA is the beneficiary in the amount of \$1 million.

Due to lack of familiarity with the operations of PIPCO SPC and its newness in the reinsurance market, the MDI performed additional reviews to understand the management and operations of PIPCO SPC and how PPIA could be affected by the new agreement. MDI's review noted that some of the founders and management of PIPCO SPC are also member-insureds and/or members of the management of PPIA. Some of the policyholders of PPIA are stockholders in the reinsurance company; however, PPIA was unable to disclose the exact identity of the shareholders. MDI also contacted the Cayman Islands Monetary Authority to ascertain the ownership of PIPCO SPC and its capitalization. The Monetary Authority was able to verify the existence of PIPCO SPC but would not provide any additional information.

MDI also asked for a risk transfer evaluation of the reinsurance agreement but PPIA was unable to provide such an evaluation. The MDI performed a cursory evaluation of the relationship and determined that the reinsurer was not accepting significant risk under the agreement based on the terms of the contract. It is very likely that the reinsurer will be profitable.

Thus, the current arrangement is deemed to constitute a related party transactions lacking in the structures and benefits of an arms length transaction and appears to be preferential to certain policyholders of PPIA. It was also noted by the MDI that PIPCO SPC is not an admitted carrier in Missouri. PPIA should be aware that reserve credits are not allowed on cessions to unauthorized carriers, such as PICO SPC unless adequate security is provided that is acceptable to the MDI. PPIA should disclose the related party nature of the agreement and all other related features in future Annual Statements and also continue to evaluate the relationships under the agreement to be certain that it is beneficial for the entire membership of the Association.

Assessments

The Association should be made aware that the Missouri Legislature recently passed House Bill 1837. If signed into law by the Governor, and as applicable, Missouri 383 companies should amend their existing Bylaws and Articles of Association regarding certain aspects of member assessments. The Association should then file such amended Bylaws and Articles of Association with the Missouri Department of Insurance to determine compliance with this legislation.

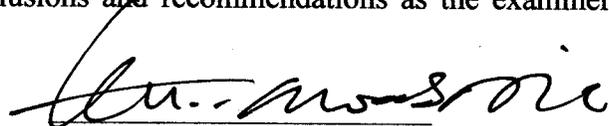
ACKNOWLEDGMENT

The assistance and cooperation extended by the officers and the employees of Physicians Professional Indemnity Association during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Leslie Nehring, CFE, and Andy Balas, CFE, AES, examiners for the Missouri Department of Insurance, participated in this examination. The firm of Expert Actuarial Services, Inc. of Chesterfield, Missouri also participated as a consulting actuary.

VERIFICATION

State of Missouri)
)
County of)

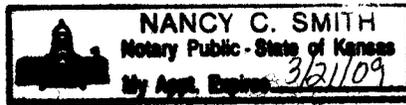
I, Levi N. Nwasoria, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of Physicians Professional Indemnity Association, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.



Levi N. Nwasoria, CPA, CFE
Examiner-In-Charge
Missouri Department of Insurance

Sworn to and subscribed before me this 27 day of July, 2006.

My commission expires: 3/21/09


Notary Public

SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with NAIC procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.



Frederick G. Heese, CFE, CPA
Audit Manager
Missouri Department of Insurance

RECEIVED
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FINANCIAL INSTITUTIONS &
PROFESSIONAL REGISTRATION

PHYSICIANS PROFESSIONAL INDEMNITY
ASSOCIATION

RESPONSE TO MISSOURI DEPARTMENT OF INSURANCE
FINANCIAL EXAMINATION
AS OF DECEMBER 31, 2005

September 11, 2006

Physicians Professional Indemnity Association (PPIA) has reviewed the Financial Examination Report prepared by the Missouri Department of Insurance (MDI). Notice to conduct this financial examination was provided to PPIA by MDI on the December 23, 2005 (See attached exhibit 1) Pursuant to said notice, PPIA has complied with MDI's request for records and information. PPIA have complied with the requests of the Department despite PPIA's position that the Missouri Department of Insurance lacks any statutory authority to conduct a financial examination of an insurance association formed under Chapter 383 of the Revised Statutes of the State of Missouri. MDI has not only acted ultra vires in conducting said examination, but has also failed to follow the NAIC Examiners Handbook, in direct contradiction to the Revised Statutes of the State of Missouri. Section 374.190 RSMo which is applicable to a Chapter 383 company authorizes "investigations" of companies for violations of the insurance laws of the State of Missouri, not financial examinations. Sections 374.202 RSMo through Section 374.207 RSMo which authorizes financial examinations are specifically excluded as a statute applicable to a Chapter 383 RSMo company, and no other insurance law of the State of Missouri applies to an association licensed pursuant to the provisions of Chapter 383 RSMo. Section 374.045 RSMo provides authority for the Missouri Department of Insurance to make reasonable rules and regulation, however pursuant to said Statute, no rule or regulation shall conflict with any laws of the State of Missouri, which includes Chapter 383 RSMo. The Code of State Regulations, Title 20 - Department of Insurance, Division 200 - Financial Examination, Chapter 1 - Financial Solvency and Accounting Standards, Section 20 CSR 200-11.010 (1) (b) specifically defines an insurer as any company or business entity authorized to transact or applying for authority to transact business of insurance in Missouri under under Chapter 376, 377, 378, 379, 381 or 384 RSMo. Chapter 383 RSMo is **specifically excluded** from the Rules promulgated by the Department of Insurance. Furthermore Chapter 383.010.1 RSMo does not provide authority for the MDI to conduct financial examinations. This section is an authoritative statute allowing the formation of insurance associations by architects, physicians, hospitals and attorneys. There is no language in this section granting authority to the Department to conduct a financial examination of a Chapter 383 RSMo association. Section 383.030 RSMo originally went into effect June 26, 1975. Originally this section stated :

"1. The director of insurance shall be authorized in accordance with Sections

375.171 and 375.173, RSMo to examine into the affairs of any association organized under the provisions of Section 380.101 to 383.040 and may, in accordance with Section 375.426, RSMo make such rules and regulations as may be necessary for the execution of the functions vested in him. Annually, thereafter, within thirty days before the expiration of its license, each association shall pay a renewal license fee of one hundred dollars and shall file a statement with the Director of Insurance giving a report of its activities for the preceding year. 2. Any existing association shall also, at the time it files for renewal of its license, file any amendments to its articles of association or bylaws which have been adopted in the preceding year”

This original version failed to include any statutory authority for “financial examinations”. In 1992 Section 383.030 RSMo was amended as follows:

“1. The director of the Department of Insurance shall be authorized in accordance with sections 374.190 and 374.200, RSMo or in the event that either or both such sections are repealed, then any successor sections relating to financial examinations, to examine the financial condition, affairs and management of any association organized under the provisions of Section 383.101 to 383.040, and the association shall pay the expenses of any such examination in accordance with Sections 374.160 and 374.220, RSMo Annually thereafter, within thirty days before the expiration of its license, each association shall pay a renewal license fee of one hundred dollars. 2. Any existing association shall also, at the time it files for renewal of its license, file any amendments to its articles of association or by laws which have been adopted in the preceding year.”

Also during 1992, Missouri House Bill 1574 was approved which repealed one hundred and one (101) sections of the Revised Statutes of the State of Missouri and enacted one hundred and twenty (120) new sections. Among the Sections that were repealed, were Sections 374.190 RSMo and 374.200 RSMo. A new Section 374.190 RSMo was enacted and 374.200 - *Record to be Kept*, was abolished. The 1967 version of Section 374.190 RSMo that was in affect at the time of the 1992 repeal specifically stated that the department shall examine and inquire into all violations of the insurance laws of the state and examine the financial condition, affairs and management of any insurance company incorporated by or doing business in Missouri. The statute further stated that the Department will inquire into and investigate the business of insurance transacted in Missouri by any insurance agent , broker, agency or insurance company. Section 374.200 RSMo which was in affect in 1992 stated:

“Said director shall keep and preserve in a permanent form a full record of his

proceedings, including a concise statement of the condition of every company whose affairs he shal have examined."

In 1992 the new Section 374.190 RSMo was enacted. Section 374.190 RSMo has no successor in that Section 374.190 RSMo is still in affect. This Section is now titled "374.190 - Investigation of companies" as opposed to the prior language which was titled "374.190 - Examination of companies." Both Section 383.030 RSMo and 374.190 RSMo were amended the same year and it is presumed that the legislature was aware and intended the effect of any amendment, enactment or repeal of statutes. Also in 1992, House Bill 1574 created Section 374.202 through 374.207 RSMo. Contained therein is Section 374.205 RSMo entitled "*Examination, director may conduct when, required when - required when - duties- nonresident insurer, options, procedures - reports, contents, use of - hearings, procedures - working papers, records, confidentiality.*" There is no reference contained within Section 374.202 through 374.207 RSMo specifically stating that these sections are applicable to a Chapter 383 RSMo association as required under Chapter 383.035.5 RSMo, nor does Chapter 383.030 refer to Sections 374.202 through 374.207 RSMo.

Further 20 CSR 200-1.060 entitled "Chapter 383 Malpractice Associations and Financial Condition" was rescinded May 6, 1993. No other rule has been promulgated as a replacement.

In addition PPIA disputes the nature in which the Department conducted the examination. Section 374.205 R.S.Mo specifically states:

"In scheduling and determining the nature, scope and frequency of examinations, the director may consider such matters as the results of financial statement analyses and ratios, changes in management or ownership, actuarial opinions, reports or independent certified public accountants, consumer complaints, and other criteria set forth in the Examiner's handbook adopted by the National Association of Insurance Commissioners and in effect when the director exercises discretion pursuant to this section." 2. (1) Upon determining that an examination should be conducted, the director or the director's designee shall issue an examination warrant appointing one or more examiners t perform the examination and instructing them as to the scope of the examination. In conducting the examination, the examiner shall observe those guidelines and procedures set forth in the Examiners' handbook adopted by the National Association of Insurance Commissioners. The director may also employ such other guidelines or procedures as the director may deem appropriate." The Examiners Handbook is very specific

as to conduct, use of specialists, controlling costs, monitoring the work performed, examination memorandum, time budgets, billing hours, etc. This is contrary to the Department's legal counsels interpretation that sections of the HB may be used or disregarded at the discretion of the Department (see attached Exhibit 2).

As the direct result of the ultra vires acts of the Department , PPIA has incurred examination expenses that exceed \$130,000.

While PPIA will respond to the comments contained within the Examination Report, PPIA does not consent to the jurisdiction of the Department to conduct a financial examination nor does the Association waive any objections defenses, remedies, judicial review, injunctive relief, costs or damages that the Association has or may incur as a result of the actions, demands, statements and conduct of the Examiner and the Missouri Department of Insurance or its agents, employees, subcontractors and personnel.

CORRECTIONS & COMMENTS

There are several errors contained within the Examination. These errors should be noted and corrected:

1. Officers - The officers of PPIA elected and serving as December 31, 2005 were as follows:

Robert C. Young, MD	President
Benny Thomas, DO	Vice President
Robert L. Hall, MD	Secretary
Carl F. Patty, MD	Treasurer
Jonathan L. Downard, JD	Executive Vice President

Benny Thomas, DO was elected as Vice President by the Board of Directors of PPIA on August 20, 2005 as set forth in the minutes of the August 20, 2005 Board Meeting.

2. Insurance Products and Related Practices - General - PPIA is *entirely* owned by the member/policyholders contrary to the Examination statement that PPIA is "primarily owned" by the member insureds.

RESPONSE TO GENERAL COMMENTS
AND/OR RECOMMENDATIONS

Capital Stock (page 2) -

Physicians Professional Indemnity Association (PPIA) was formed pursuant to Chapter 383 RSMo after approval by the Missouri Department of Insurance (MDI). The Association's Articles of Association, Bylaws, policy, endorsements, and business plan were thoroughly reviewed by the Department and upon review, a Certificate of Authority was issued May 15, 2003 to the Association and has been re-issued each year since. Chapter 383 RSMo. (or as amended) does not require an Association to assess ex-members, nor does the Statute require this to be a requirement or condition of membership. No Statute applicable to a Chapter 383 RSMo association, nor any provision of the Code of State Regulations requires the same, nor was the assessment of ex-members required as a condition precedent to the approval of the Association's Certificate of Authority by MDI. In addition, recent legislation does not require the assessment of ex-members, but rather simply requires the assessment ability of an Association to be specified in the Articles of Incorporation. PPIA respectfully disagrees with the Department's belief that good business practice dictates the ability to assess ex-members. Other Chapter 383 Associations have in fact circulated correspondence to Missouri physicians concerning this issue and have included a statement from MDI in support (see attached Exhibit 3) of the fact that the Department is not aware of any assessments made by any Chapter 383 RSMo association. PPIA is not aware historically of any other Chapter 383 RSMo association that has incorporated such an assessment feature in its Articles of Association or By-laws. Should such a provision be mandated by Statute or Code of State Regulations, PPIA will fully comply.

Management (page 3)

The Articles of Association, and bylaws of PPIA filed with both the Missouri Secretary of State and the Missouri Department of Insurance, in 2003, state as follows:

Articles of Association, Article IX - *The property and business of the Association shall be managed and controlled by a Board of Directors. The Board of Directors shall be twelve (12) in number.*

Bylaws, Article III - Board of Directors - *The property and affairs of the Association shall be controlled and managed by a Board of Directors. Twelve directors shall constitute the Board of Directors. A minimum of three (3) and maximum of nine (9) directors shall be physicians and at least three (3) shall*

be business experienced persons.

Section 351.320 RSMo sets forth a mechanism for filling vacancies or newly created directorships. No Missouri Statute or provision of the State Code of Regulations prohibits a Board of Directors from functioning with vacancies, nor requires an Association or Corporation to maintain a “full” Board of Directors with no vacancies. As the Association continues to grow, PPIA will examine candidates for the Board of Directors based on the requirements of the Articles of Association and Bylaws, candidate qualifications, as well as the geographical representation of the Board members in relation to the overall membership. This will assure that the membership of PPIA is properly represented and that the differing needs of physicians throughout Missouri are considered by the Association. PPIA has no intention to reduce the number of Directors set forth in the Articles of Association and Bylaws and will fill the vacant Board positions as the Association expands in membership throughout the State of Missouri.

Conflict of Interest (page 4) -

PPIA has adopted a Policy on Conflicts of Interest and require all Board Members and Officers to complete and sign a Disclosure Statement in connection with the Association’s policy on conflicts of interest. The Policy on Conflicts of Interest and Disclosure is provided to all Directors and Officers upon appointment, election or re-election. All Directors and Officers are required to complete the Disclosure Statement at which time it is maintained as part of the records of the Association. The Statement of Disclosure specifically requires an on-going duty and responsibility to report any changes that could result in a conflict of interest as follows:

6. I will promptly notify the association if after the date of this statement I acquire any interest or engage in any activity which would have to be disclosed as an exception to any of the preceding statements.

No Missouri Statute applicable to a Chapter 383 company, nor any regulation set forth in the CSR, requires a conflict of interest disclosure statement to be signed annually rather than at the time the individual assumes office, re-elected or re-appointed. One-third of the Board positions are held for a period of three (3) years, one-third are held for two (2) years and one-third are held for one (1) year. All other officers are appointed for one (1) year terms. PPIA has adopted the position that changes which create a conflict may take place within one year, six months, one month etc. The Association believes that the completion of the Disclosure Statement as currently utilized, incorporating the on-going duty to disclose any conflicts, is satisfactory and in compliance with Missouri law and prudent business practices.

Fidelity Bond and Other Insurance (page 5) -

PPIA currently maintains a fidelity bond with a liability limit of \$50,000. PPIA has reviewed the Missouri Statutes applicable to a Chapter 383 Association, the CSR and the NAIC Examiners Handbook and the Association is unaware of any specific statute, rule or NAIC guideline that requires the Association to maintain a fidelity bond with minimum liability limits of \$150,000. If, upon review, the applicable Statute or rule requires PPIA to increase the bond minimum, the Association will so comply.

Agreement with MSMA (page 8) -

PPIA has entered into an agreement with the Missouri State Medical Association Insurance Agency (MSMAIA) wherein MSMAIA receives a commission based on ten percent (10%) of the written premium, and in addition receives a two percent (2%) universal commission on PPIA policies written by other producers as well. This additional commission was established to encourage the development of contractual and business relations by MSMAIA with other producers in expanding marketing and promoting PPIA throughout the State of Missouri. The additional commission also served as a recognition of costs associated with educating producers within the MSMAIA agency and other agencies on the various aspects of the PPIA product, marketing conduct and underwriting standards. PPIA will review the two percent (2%) universal commission and determine whether the same shall be phased out and terminated. If the universal commission continues, the contract will be modified to include the duties and responsibilities of the agency.

Overall - Agreements with Third Parties (page 9) -

PPIA has reviewed the directive for each of the agreements with third parties and to report the yearly amounts paid to each party in the “Notes to the Financial Statement” of the Annual Statement under “Information Concerning Parent, Subsidiaries and Affiliates” section. PPIA will comply with this directive in future annual statements.

Notes to Financial Statement (pages 15 through 18) -

PPIA disputes the findings of the Examiner as noted below and states that the findings are the result of Examiner error, the Examiner’s reliance on faulty, unreliable data and suppositions that are not factual. PPIA responds as follows:

Note One (page 15) -

PPIA accepts the reclassification as set forth in Note One based on the investment in

a Charles Schwab and Company money market fund not listed on the exempt list. PPIA will report the money market fund as common stock on future Annual Statements should PPIA continue to maintain such an account. PPIA will request a detailed list of the specific portions of the NAIC Examiners Handbook that is applicable due to the Departments position that not all portions of the NAIC Examiners Handbook are mandatory or applicable.

Note Two (page 15-16) -

PPIA disputes the findings of the Examiner and believes that the findings are the result of Examiner error. PPIA did not incorrectly record the annualized premium. Although the policyholders, in majority of cases, paid premiums on a fractional mode, (monthly, quarterly, etc.) the Association issues all policies to members for a period of twelve (12) months. No policies are issued monthly, quarterly or semi-annually. The member may elect a fractional mode of payment which does not affect the policy duration or contractual obligations of the Association and member. All policies are issued with an invoice for the annual premium, as well as the fractional mode payment option including the applicable interest charges. The policy is billed for the one year policy period and the interest on the fractional mode payment is calculated on a twelve (12) month basis. No billing statement has been issued by the Association that indicates a payment less than the full twelve (12) month policy period. Further the Association is not aware of any other insurance carrier that is required to report uncollected premiums in the fashion set forth in the Examiner's notes. PPIA has reviewed this issue and the accounting methods suggested by the Examiner are not applicable to a medical malpractice insurance company. The Examiner's comments only apply to companies issuing workers compensation policies. NAIC SSAP 53, paragraph 5 states that "written premium for all other contracts (other than workers compensation) shall be recorded as of the effective date of the contract." If premium is written, it must be recorded in receivables and unearned premiums. The only exception to that general rule is stated in paragraph four (4) which provides that workers compensation contracts may be recorded in an installment basis. Issue paper 53 restates this rule. Specifically, Paragraph 13 states that the intention is to improve consistency in reporting so the only exception is workers compensation, and attempts to apply installment reporting for other lines of business are specifically rejected. (See attached Exhibit 4) PPIA properly and accurately reported its uncollected premium.

Note Three (page 16-17) -

Expect Actuarial Services, LLC (EAS) was engaged by MDI to perform an actuarial

review of the loss and loss adjusted expense reserves of PPIA. The data and information created by EAS and relied upon by EAS in conducting the review of PPIA was inaccurate, not based on adequate data, and provides limited credible inferences. The uncertified EAS report relied upon faulty claim review data derived from a subcontractor of EAS - Kentfield & Associates, rather than case reserve adequacy based on a comparison of PPIA's reserves to Missouri specific claim statistics. The EAS report must be examined on the strength of the underlying data created and utilized by EAS is inaccurate and faulty. Utilizing the claim information as the foundation for the EAS study, the entire study is suspect and inaccurate. While PPIA has requested data from the MDI, concerning Kentfield & Associates qualifications, expertise, Missouri medical malpractice experience, etc, MDI has failed and refused to provide this information to PPIA, in order to allow PPIA to evaluate the underlying data and to fully respond to this examination report. In addition while the EAS report cites the "independent" claims review conducted by Kentfield & Associates, the review may not be independent of EAS. Without MDI forthcoming with further information as requested by PPIA, it appears that the claims review was not independent, but rather particularly pre-examination result oriented and biased. The EAS report which is based upon the "claims review", does not contain enough reliable data and information to make the assumptions that are contained in the EAS report, specifically that the case reserves are inadequate. There are numerous examples of EAS failure to monitor the claims review and insure that accurate information would be used as a basis for the EAS report. These errors include:

A. The claims report is not a accurate review of cases reserves vs. case development as of December 31, 2005. The case review utilized April 2006 discoverable case information compared to December 31, 2005 reserves rather than December 31, 2005 case information compared to December 31, 2005 case reserves.

B. The case reserve study methodology is based on arbitrary reserve values associated with the MDI claim report severity code. No documentation is provided to ascertain ultimate values, rather than subjective opinions based on severity then matched to a general "outline" process again based on subjectivity.

C. The claims examiner specifically pre-selected cases for review rather than utilizing a random sample of claims. In addition the information available, the small number of claims for which indemnity payments have been made by PPIA, the short duration of the Association, and the anomaly of claims filed in response to tort reform, fails to provide sufficient empirical data to make any

sampling reliable.

D. Suggested reserves set forth in the claims review are not reliable. The EAS report states that all case reserves should be “roughly” doubled despite the fact that case development had demonstrated a pattern that the reserves established by PPIA are in fact accurate. EAS makes an assumption despite the fact that the claims review states that approximately two-thirds of the PPIA case reserves were adequate or too large.

E. The claims review did not utilize the 2006 claim reserve figures established by PPIA at the time of the review.

F. EAS, through its selected subcontractor, reviewed only discoverable claim information contained in the Association’s claim files as opposed to non-discoverable claim information, expert review, medical records, statements of physicians and plaintiff, attorney-client privileged case development or defense attorney confidential notes. This is despite the fact that claims review personnel consumed an inordinate amount of time reviewing files, many of which contained “immature” claims which had only recently been filed. EAS claims review personnel did not meet with any defense attorneys to discuss the development of claims and though available, failed to inquire completely, adequately or in many cases, at all with PPIA’s corporate counsel concerning individual case development.

G. EAS utilized personnel whose expertise is highly suspect. PPIA has requested information from MDI concerning the expertise of the claims review personnel, due to the fact that the EAS report, upon which the Department relies, is likewise based upon the claims study. This information would be useful for PPIA to fully and completely respond to the Examiner’s report. However MDI has refused and failed to provide this information to PPIA taking the position that this information is confidential. PPIA’s preliminary investigation has determined that the claims review personnel is not an attorney, is not authorized to practice law in the State of Missouri, and to PPIA’s knowledge, has never conducted a jury trial or prepared the defense for a medical malpractice trial in the State of Missouri. It is further PPIA’s belief that the EAS claims review personnel is not a physician, has never had medical training as such or held a medical license, and is not qualified to determine and comment on the medical standard of care. Further PPIA is not aware of any special knowledge that the EAS claims review personnel has of the medical malpractice market in the State of Missouri, nor that the individual has had any involvement with the Missouri medical malpractice insurance industry. It is further the

understanding of PPIA that the EAS claims review personnel is not a CPA, actuary, or mathematician, has no publications that the Association has been able to review, no articles, no thesis or manual or book considered authoritative on medical malpractice claims and claim reserves. The information available to the Association indicates that the individual that conducted the case review relied upon by EAS, and subsequently the Examiner, has a primary area of concentration in workers compensation. PPIA further reviewed the professions listed by the Missouri Division of Professional Registration and said Division fails to list an “insurance claims expert” as a regulated or recognized profession. Ultimately the claims review personnel utilized by EAS offered but one opinion of PPIA’s claims. This opinion utilized by EAS as authoritative, ignores the opinion of PPIA’s Claims and Settlement Committee which is composed of four physicians, two attorneys, and an experienced insurance executive, as well as seasoned, successful defense counsel, all of whom have complete knowledge and access to non-discoverable records, expert review and assessment, complete case review and development.

G. No Missouri statute applicable to a Chapter 383 RSMo association, no CSR or other rule or regulation requires a specific, industry uniform methodology in establishing and posting reserves, reserve periods or ultimate claim values based upon severity codes.

Because of the above, the claim review utilized by EAS is unreliable, and forms a defective basis for the Examiners results and findings. The EAS report relies heavily on broad industry benchmarks that do not specifically reflect loss activity in the State of Missouri. To support the EAS findings, EAS has relied upon the claims review performed by EAS’s subcontractor as evidence of the case reserve inadequacy. The case review does not contain the necessary, accurate information for which to base the assumption that case reserves are inadequate. In utilizing faulty, inaccurate and defective data, the EAS report is at the best suspect and corrupts the accuracy and reliability of the Examiner’s findings.

PPIA strongly disagrees with the findings set forth in Examiners Note Three (3), and the Association is of the opinion based on the complete information available to PPIA, as well as the certified actuarial statement filed with MDI, that the case reserves are adequate and that no deficiency exists.

Note Four (page 17) -

PPIA has reviewed the amounts reported as commissions payable. Due to the numerous requests by the Examiner for information beyond the December 31, 2005 examination

period, and in an effort by PPIA to fully report and disclose all information, the Association erred in including commissions due to agents during the period of January 1 through January 15, 2006. PPIA will comply with the directives of Note Four as it applies to the Commissions Payable line of the Annual or Quarterly Financial Statement.

Note Five (page 18) -

PPIA did not err in calculating the Associations Gross Unearned Premium on all written policies, by improperly annualizing the premiums. PPIA issues annual policies for professional liability insurance. All premiums for said insurance coverage are billed to the member/policyholder on an annual basis and invoices are sent to the policyholder at the time of issue for the entire annual premium. If a fractional mode of payment is selected by the physician, an appropriate finance charge is included based upon the annual period of the policy. Therefore all premium is due to the Association from the member/policyholder upon issuance of the professional liability insurance policy and as such PPIA correctly, logically and accurately reported unearned premium. In addition PPIA has complied with NAIC SSAP 53. If the position of MDI is to disregard this NAIC directive, then PPIA would respectfully request the Department specifically address in writing which sections of the NAIC SSAP and NAIC Examiners Handbook shall apply for future compliance.

PPIA utilized a conservative approach to the application of a cession rate of the Gross Written Premium pursuant to the reinsurance contract. An arbitrary cession rate was not established by the Association but rather the Association reviewed the reinsurance contract and, taking into account the commissions paid to brokers by Lloyds, extrapolated the true cost of reinsurance from the reinsurance premium. PPIA utilized a rate of 17.5% rather than the stated 27.5% as stated in the reinsurance agreement. PPIA accepts the recalculation of the Ceded Unearned Premium reserve using the rate of 27.5% and will in the future utilize the ceding rate set forth in any PPIA reinsurance agreements.

PPIA does not agree with the net effect of the Examiners adjustment resulting in Net Unearned Premium of \$896,238 as of December 31, 2005. PPIA will calculate its Ceded Unearned Premium in the future using the cession rate that is utilized to calculate the actual ceding premium paid to the reinsurer as established in the reinsurance contract.

Note Six (page 18) -

PPIA has properly annualized the policy finance charges based upon the discussion set forth above and the authoritative NAIC SSAP. PPIA restates the facts, reasoning and support set forth above. The finance charges recorded were unearned as of quarter or year end, accurately recorded, and thus not overstated.

Note Seven (page 18) -

The Association strongly disputes the Examiner's conclusion that the Association was insolvent as of December 31, 2005. Due to Examiner error, improper, unnecessary and unsubstantiated adjustments, as well as the reliance upon unreliable, inaccurate data, the surplus of the Association is misstated and reduced to the sum set forth in the Examination report. PPIA believes that such statements as to the financial viability of the Association grossly, negligently and intentionally misrepresents the surplus and financial solvency of the Association.

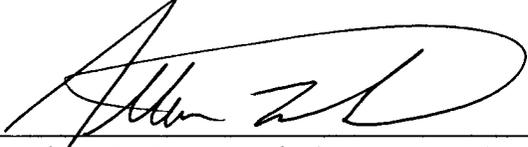
Subsequent Events

Reinsurance: PPIA entered into a reinsurance agreement with PIPCO SPC April 1, 2006. This reinsurance agreement is beneficial to the PPIA membership in that the cost of reinsurance was significantly reduced, the duration of the reinsurance contract was increased, and the terms of the agreement were more beneficial to the Association. All though this reinsurance agreement was subsequent to the examination period of December 31, 2006. PPIA fully complied with the document requests of the Examiner and provided the information requested. In addition PIPCO SPC has established the necessary trust account and has funded the same, currently maintaining said funds in the Bank of Washington, Washington, Missouri. The trust agreement was forwarded to MDI for review and comment on the 10th day of July, 2006 and as of the time of this response, no comment or response has been received from MDI. PPIA is conducting a risk transfer evaluation of the reinsurance agreement however said evaluation is not complete as of the date of this response. The Examiner's statement that PPIA was unable to provide such an evaluation does not fully reflect the actions of the Association. PPIA is not aware of any statute applicable to a Chapter 383 RSMo company that requires PPIA to maintain reinsurance or to disclose and or file with MDI any additional information concerning the reinsurance agreement. PPIA has examined the reinsurance agreement and presented the same to the membership of the Association for approval. It is PPIA's opinion that the agreement benefits the entire membership of PPIA.

Assessments: PPIA is aware of House Bill 1837 which went into effect on August 28, 2006. While this legislation certainly is not applicable to the examination period, PPIA has complied with the applicable Missouri Statutes and rules applicable to a Chapter 383 RSMo association and will continue to do so in the future.

Respectfully Submitted:

PHYSICIANS PROFESSIONAL INDEMNITY ASSOCIATION

BY: 

Jonathan L. Downard, Attorney at Law

Executive Vice-President & Corporate Counsel

EXHIBIT 1

State of Missouri



Matt Blunt, Governor

Department of Insurance
P.O. Box 690
Jefferson City, Missouri 65102-0690

W. Dale Finke
Director

December 23, 2005

Robert C. Young, President
Physicians Professional Indemnity Association
3401 W. Truman Blvd.
Jefferson City, MO 65109

Dear Mr. Young:

This letter is to inform you that the Missouri Department of Insurance will conduct an examination of your company commencing within the next six months. It is anticipated that the examination will be performed as of December 31, 2005. The Audit Manager assigned to supervise this examination is Frederick G. Heese, who will contact you when the examination start date is nearer. The on-site examiner-in-charge conducting this examination will be financial examiner, Levi Nwasoria. He will be assisted by two Missouri examiners.

I would appreciate that arrangements be made to provide the examiners with adequate workspace and facilities for this audit. At least one dedicated telephone line will be necessary for PC modem use. I am also requesting that the company ensure that the examiners receive all requested information in a timely manner.

I thank you in advance for your cooperation. Should you have any questions regarding this examination, please contact Frederick G. Heese, Audit Manager, Kansas City, Missouri Department of Insurance, 615 East 13th St., Room 510, Kansas City, MO 64106-2829 or call 816 889-2219.

Sincerely,


KIRK SCHMIDT, CFE, CPA
Chief Financial Examiner

KS/ams

Certified Mail No. 7002 0460 0003 0701 9304
Return Receipt Requested

c: Frederick G. Heese, Audit Manager
Levi Nwasoria, Examiner-in-Charge
James R. Snodgrass, Contact Person

EXHIBIT 1

State of Missouri



Matt Blunt, Governor

Department of Insurance
P.O. Box 690
Jefferson City, Missouri 65102-0690

W. Dale Finke
Director

December 23, 2005

Robert C. Young, President
Physicians Professional Indemnity Association
3401 W. Truman Blvd.
Jefferson City, MO 65109

Re: Access to CPA Workpapers in the Financial Examination of Physicians Professional Indemnity Association

Dear Mr. Young:

This letter is to inform you of the necessary access to your CPA's workpapers and their staff, that the Missouri Department of Insurance will require in conjunction with the financial examination of Physicians Professional Indemnity Association as of December 31, 2005.

It is mandated by statute that your CPA firm must provide the Missouri Department of Insurance access to its workpapers. The statutory requirement for such is provided in Section 375.1050 RSMo., as follows:

"...shall require the accountant to make available for review by the examiners of the department of insurance all workpapers prepared in the conduct of his examination and any communications related to the audit between the accountant and the insurer..."

Pursuant to this statute, *"...workpapers' are the records kept by the independent certified public accountant of the procedures followed, the tests performed, the information obtained and the conclusions reached pertinent to his examination of the financial statements of an insurer. Workpapers may include audit planning documentation, work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, any communications between the accountant and the insurer, and schedules or commentaries prepared or obtained by the independent certified public accountant in the course of his examination of the financial statements of an insurer..."*

The intentions of the above statute is to allow for reliance to be placed on the work of your CPAs by the financial examiners of the Missouri Department of Insurance in their examination, ensuring minimal duplication of audit work and cost. Any problems that occur in receiving access to your CPA's workpapers will likely increase the time and cost necessary to perform the examination.

Failure of an accounting firm to provide access to their workpapers may lead to the accountant's statutory audit opinion being unacceptable to the Missouri Department of Insurance. This would place your company in a difficult position, since you may then be required to replace the work already performed by your CPAs and may prevent further use of them in future periods. Depending on the circumstances, any CPA firm not cooperating on a particular examination could also be deemed unacceptable for the audits of other Missouri domestic insurance companies.

You are requested to communicate to your CPA firm that it should comply fully with the Missouri Department of Insurance in the examination of your company by providing access to all workpapers and staff members involved in the audit of Physicians Professional Indemnity Association. Your cooperation in ensuring this is appreciated.

Thank you in advance for your cooperation. Should you have any questions regarding this matter, please contact Fred Heese, Audit Manager, Missouri Department of Insurance, 615 East 13th St, Room 510, Kansas City, MO 64106 or call 816-889-2219.

Sincerely,



KIRK SCHMIDT, CFE, CPA
Chief Financial Examiner

KS/ams

Certified Mail No. 7002 0460 0003 0701 9304
Return Receipt Requested

c: Fred Heese, Audit Manager
Levi Nwasoria, Examiner-in-Charge



Department of Insurance
P.O. Box 690
Jefferson City, Missouri 65102-0690

W. Dale Finke
Director

July 17, 2006

Jonathan L. Downard
Hansen, Stierberger, Downard, Melenbrink & Schroeder LLC
80 North Oak Street
Union, MO 63084

Re: PPIA Examination Invoices #603001 and #603002

Dear Mr. Downard:

This is in response to your July 11 letter. The Department again determines that its examination of PPIA and the invoices to PPIA arising out of such examination are within the scope of the Department's authority.

Section ~~383~~383.030.1, RSMo, authorizes the Department to conduct a financial examination and requires a chapter 383 association to pay for it. The cross-references in that statute state the procedures to be used in conducting the examination and in paying for it. As they relate to financial examinations, sections 374.202-374.207, RSMO, are successor sections to sections 374.190 or 374.200, by reason of the enactment of sections 374.202-374.207, RSMo, in the same bill that repealed sections 374.190 and 374.200 and then re-adopted only section 374.190 but without reference to examinations.

Regarding your reference to the Examiner's Handbook, section 374.205.1(1) refers only to the scheduling and determining the nature, scope and frequency of examinations, not to the conduct of the examination itself, and makes the use of the EH discretionary with the director. The provisions of subsection 2, subdivision (1), relating to use of the Examiner's Handbook during the examination, make use of the EH mandatory only upon the examiner and grant the director discretion to "employ such other guidelines or procedures as the director may deem appropriate".

You have requested access to more specific billing information regarding the actuarial study and the claims study and question the authority for the claims study conducted by Kentfield & Associates. That request is denied because such information would fall within the scope of "working papers, recorded information, documents and copies thereof produced by, obtained by or disclosed to the director or any person in the course of an examination made pursuant to... [section 374.205, RSMo]." See section 375.205.4, RSMo. Accordingly, any such record "shall be given confidential treatment and [is] not subject to subpoena and may not be made public by the director or any other person" subject to certain exceptions inapplicable to your request. See section 374.205.4, RSMo. The work performed on the claims study is authorized under the Miscellaneous Services portion of the contract with Expert Actuarial Services. See RFP 2.2.9. Sections 2.4.8 and 2.4.9 allow for substitution of the

July 17, 2006

subcontractor with approval of the agency. The Department approved the selection of Kentfield and Associates after reviewing the qualifications of Mr. Kentfield, whose work was billed at only \$265 per hour, which is less than the contract rate for miscellaneous services.

The Department shares your hope that the issues surrounding the examination of PPIA may be resolved amicably. The resources of both PPIA and the Department are better used in the objective and independent verification of PPIA's financial condition. If you would like to meet to discuss this matter further, please contact my administrative assistant or me at (573) 526-4877 to arrange a mutually convenient time.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark W. Stahlhuth", with a long horizontal flourish extending to the right.

Mark W. Stahlhuth, Senior Counsel
Division of Financial Regulation

EXHIBIT 3

State of Missouri



Bob Holden, Governor

Department of Insurance
P.O. Box 690
Jefferson City, Missouri 65102-0690

Scott B. Lakin
Director

April 21, 2004

Paul E. Schoenlaub
Missouri Doctors Mutual Insurance Company
P. O. Box 914
Saint Joseph, MO 64502

Re: Chapter 383 Company Statistics Question

Dear Mr. Schoenlaub:

This is in response to your April 15 letter. You ask two questions, whether or not any chapter 383 company has failed or become insolvent and whether a chapter 383 company has ever made a special assessment.

The Department of Insurance knows of no prior failures or insolvencies of a chapter company. Most chapter 383 companies either become so successful that they convert their company into a company organized pursuant to chapter 379 or are unsuccessful and voluntarily wind up their operations with Department of Insurance oversight.

Likewise, the Department of Insurance knows of no prior special assessments by a chapter 383 company. Such an assessment may have taken place, but the Department does not keep specific records of chapter 383 companies' assessments.

If you have further questions regarding the operations of a chapter 383 company, you may contact Kirk Schmidt, the Director of the Division of Financial Regulation.

Sincerely,

A handwritten signature in black ink, appearing to read 'Scott B. Lakin', written over a horizontal line.

Scott B. Lakin
Director

Paul I hope this is helpful!

**Uncollected Premium Balances, Bills Receivable
for Premiums, and Amounts Due From Agents and Brokers**

SSAP No. 6

Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for direct and group billed uncollected premiums, bills receivable for premiums, and amounts due from agents and brokers (collectively referred to as agents).
2. This statement does not address uncollected and deferred premiums for life considerations.

SUMMARY CONCLUSION

3. Premium transactions conducted directly with the insured result in uncollected premium balances.
4. Bills receivable, which are generally interest bearing, are used by reporting entities as a method of financing premiums.
5. Amounts due from agents result from various transactions ranging from premiums collected by the agents on behalf of the reporting entity to amounts advanced to the agent by the reporting entity to finance agency operations.
6. Uncollected premium balances, bills receivable for premiums, and amounts due from agents meet the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets*, and are admitted assets to the extent they conform to the requirements of this statement. Premiums owed by agents shall be reflected net of commissions, if permitted by the contract. Balances resulting from advances to agents, which are primarily encountered in the life insurance industry, are nonadmitted if (a) the amounts are in the form of unsecured loans or advances, (b) the contractual terms for repayment are through application of future renewal commissions and/or other credits, or (c) the terms of repayment do not provide readily available cash for the satisfaction of policyholder liabilities.

Determination of Due Date

7. The due date for all premium balances addressed by this statement is determined as follows:
 - a. Original and deposit premiums—governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship;
 - b. Endorsement premiums—governed by the effective date of the insurance policy endorsement;
 - c. Installment premiums—governed by the contractual due date of the installment from the insured;
 - d. Audit premiums and retrospective premiums—governed by insurance policy or insurance contract provisions. If the due date for receivables relating to these policies is not addressed by insurance policy provisions or insurance contract provisions, any uncollected audit premium (either accrued or billed) is nonadmitted.
8. The provisions of paragraph 7 shall be applied to all balances due except those arising from force placed insurance obtained by a lender for collateral protection, certain policies, known as Trustee Sales Guarantees (TSGs), issued by title insurance companies to lenders on defaulted real estate loans and crop/hail policies. For forced placed insurance policies, the due date for purposes of applying paragraph 9 shall be the date of billing. For TSGs, the due date for purposes of applying paragraph 9 shall be the

expiration of the grace period given to the defaulted debtor, which is provided by statute. Crop/hail premiums are considered installment premiums in accordance with paragraph 7 and accordingly, the due date for purposes of applying paragraph 9 shall be governed by the contractual due date of the installment.

Impairment

9. Nonadmitted amounts are determined as follows:

- a. **Uncollected Premium**—To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days due shall be nonadmitted. If an installment premium is over ninety days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be nonadmitted;
- b. **Bills Receivable**—Bills receivable shall be nonadmitted if either of the following conditions are present:
 - i. If any installment is past due, the entire bills receivable balance from that policy is nonadmitted; or
 - ii. If the bills receivable balance due exceeds the unearned premium on the policy for which the note was accepted, the amount in excess of the unearned premium is nonadmitted.
- c. **Agents' Balances**—The uncollected agent's receivable on a policy by policy basis which is over ninety days due shall be nonadmitted regardless of any unearned premium;
 - i. If amounts are both payable to and receivable from an agent on the same underlying policy, and the contractual agreements between the agent and the reporting entity permit offsetting, the nonadmitted portion of amounts due from that agent shall not be greater than the net balance due, by agent;
 - ii. If reconciling items between a reporting entity's account and an agent's account are over ninety days due, the amounts shall be nonadmitted.

10. After calculation of nonadmitted amounts, an evaluation shall be made of the remaining admitted assets in accordance with *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5), to determine if there is impairment. If, in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in SSAP No. 5 shall be followed.

11. Amounts classified as nonadmitted assets collected subsequent to the date of the statutory financial statements shall not be used to adjust the nonadmitted asset otherwise calculated.

Wash Transactions

12. Amounts due from agents (affiliated or nonaffiliated) that are collected prior to the date of the financial statements and then repaid to the agent by the reporting entity or one of the reporting entity's affiliates subsequent to the date of the financial statements shall be accounted for in accordance with the substance of the transaction (a wash transaction) and not its form. Accordingly, the payments received shall be accounted for as deposits and a liability shall be established for the same amount. The amounts due shall be reestablished as an asset and subjected to asset collectibility and nonadmitted asset calculations using the original due date of the receivable.

13. Short-term financing by third parties shall also be considered a wash transaction if the substance of the transaction is to avoid the nonadmitted asset principle set forth in this statement.

Disclosures

14. Refer to the preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

RELEVANT ISSUE PAPERS

- Issue Paper No. 6—Amounts Due From Agents and Brokers
- Issue Paper No. 10—Uncollected Premium Balances
- Issue Paper No. 21—Bills Receivable For Premiums

Property Casualty Contracts—Premiums**SCOPE OF STATEMENT**

1. This statement establishes general statutory accounting principles for the recording and recognition of premium revenue for property and casualty contracts as defined in *SSAP No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force*.

2. Specific statutory requirements for certain property and casualty premiums are addressed in the following statements: (a) *SSAP No. 57—Title Insurance*, (b) *SSAP No. 58—Mortgage Guaranty Insurance*, (c) *SSAP No. 60—Financial Guaranty Insurance*, (d) *SSAP No. 62—Property and Casualty Reinsurance*, (e) *SSAP No. 65—Property and Casualty Contracts*, and (f) *SSAP No. 66—Retrospectively Rated Contracts and Contracts*.

SUMMARY CONCLUSION

3. Except as provided for in paragraph 4, written premium is defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract. Frequently, insurance contracts are subject to audit by the reporting entity and the amount of premium charged is subject to adjustment based on the actual exposure. Premium adjustments are discussed in paragraphs 8 through 11 of this statement.

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

5. Written premiums for all other contracts shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Flat fee service charges on installment premiums¹ (fees charged to policyholders who pay premiums on an installment basis rather than in full at inception of contract) are reported in the Other Income section of the Underwriting and Investment Exhibit as Finance and Service Charges. Flat fee service charges on installment premiums, which do not meet the requirements outlined in footnote 1 (e.g., policy may be cancelled for non-payment of fee or fee is refundable), shall be recorded as written premium on the effective date of the contract and subject to the unearned premium guidelines included in paragraph 7.

6. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of contracts shall be recognized in the statement of income, as earned premium, using either the daily pro-rata or monthly pro-rata methods as described in paragraph 7. Certain statements provide for different methods of recognizing premium in the statement of operations for specific types of contracts. For contracts not separately

¹ If the policyholder elects to pay an installment rather than the full amount or the full remaining balance, the policyholder is traditionally charged a flat fee service charge on the subsequent billing cycle(s). The amount charged is primarily intended to compensate the insurer for the additional administrative costs associated with processing more frequent billings and has no relationship to the amount of insurance coverage provided, the period of coverage, or the lost investment income associated with receiving the premium over a period of time rather than in a lump sum. As described, there is no underwriting risk associated with this service charge. If a policyholder does not pay the service charge, the policy is not cancelled (unlike non-payment of premium), but instead the policy is converted back to an annual pay plan. If a policyholder cancels coverage, the premium is returned but the service charge is not, as the service charge is not a part of premium. Clarification of finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.

identified in specific statements where the reporting entity can demonstrate the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

7. One of the following methods shall be used for computation of the unearned premium reserve:
- Daily pro rata method—Calculate the unearned premium on each policy—At the end of each period, the calculation is made on each item of premium to ascertain the unexpired portion and to arrive at the aggregate unearned premium reserve;
 - Monthly pro rata method—This method assumes that, on average, the same amount of business is written each day of any month so that the mean will be the middle of the month. For example, one-year premiums written during the first three months of the year have, at the end of the year, the following unearned fractions: January-1/24; February-3/24; March-5/24.
8. Additional premiums charged to policyholders for endorsements and changes in coverage under the contract shall be recorded on the effective date of the endorsement and accounted for in a manner consistent with the methods discussed in paragraphs 4 through 7. This is done so that, at any point in time, a liability is accrued for unearned premium related to the unexpired portion of the policy endorsement.

Earned but Unbilled Premium

9. Adjustments to the premium charged for changes in the level of exposure to insurance risk (e.g., audit premiums on workers' compensation policies) are generally determined based upon audits conducted after the policy has expired. Reporting entities shall estimate audit premiums, the amount generally referred to as earned but unbilled (EBUB) premium, and shall record the amounts as an adjustment to premium, either through written premium or as an adjustment to earned premium. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using historical company unearned premium data, or per policy calculations.

10. EBUB shall be adjusted upon completion of the audit and the adjustment shall be recognized as revenue immediately. Upon completion of an audit that results in a return of premiums to the policyholder, earned premiums shall be reduced.

11. Reporting entities shall establish all of the requisite liabilities associated with the asset such as commissions and premium taxes.

12. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis shall be reported as a nonadmitted asset. To the extent that amounts in excess of the 10% are not anticipated to be collected, they shall be written off against operations in the period the determination is made.

Advance Premiums

13. Advance premiums result when the policies have been processed, and the premium has been paid prior to the effective date. These advance premiums are reported as a liability in the statutory financial statement and not considered income until due. Such amounts are not included in written premium or the unearned premium reserve.

Premium Deposits on Perpetual Fire Deposits

14. Premium deposits on perpetual fire insurance risks should be charged as a liability to the extent of at least 90% of the gross amount of such deposit.

Premium Deficiency Reserve

15. When the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, and any future installment premiums on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings.

16. If a premium deficiency reserve is established in accordance with paragraph 15, disclose the amount of that reserve. If a reporting entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the financial statements.

Disclosures

17. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

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

18. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

19. This statement rejects *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*.

Effective Date and Transition

20. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

Statutory Issue Paper No. 10 Uncollected Premium Balances

STATUS

Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper addresses direct and group billed uncollected premiums for Property and Casualty and Accident and Health policies. It does not address uncollected and deferred premiums for life considerations, which are addressed in a separate issue paper. The Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies and for Life and Accident and Health Insurance Companies (the Manuals) do not provide definitive guidance on when to begin aging premiums. This issue paper puts forth a framework for the accounting and reporting of uncollected premium balances that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Premium transactions result in amounts due to the reporting entity that meet the definition of an asset as set forth in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. First, an evaluation shall be made to determine nonadmitted amounts. Next an evaluation shall be made of the remaining admitted assets in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), to determine whether there is an impairment. This two step process is set forth below:

- a. To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days due shall be accounted for as a nonadmitted asset. If an installment premium is over ninety days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be accounted for as nonadmitted assets.
- b. Amounts determined to be uncollectible shall be written off. If, in accordance with Issue Paper No. 5, it is probable the uncollected premium balance is uncollectible, any uncollectible premiums receivable shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

3. The following provides additional guidance in determining the nonadmitted portion of uncollected premiums:

- a. Amounts classified as nonadmitted assets collected subsequent to date of the statutory financial statements - Such amounts should not be used to adjust the nonadmitted asset otherwise calculated.

b. Determination of the Due Date -

- i. The due date for original and deposit premiums is governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship.
- ii. The due date for endorsement and installment premiums is governed by the effective date of the endorsement and the contractual due date of the installment.
- iii. The due date for audit premiums and retrospective premiums is governed by policy provisions or contract provisions. If the due date for receivables relating to audits is not addressed by policy provisions or contract provisions, any uncollected premium (either accrued or billed) is nonadmitted.
- iv. These provisions are to be applied to all premium receivables except those arising from force placed insurance obtained by a lender for collateral protection, certain policies, known as a Trustee Sales Guarantees (TSGs), issued by title insurance companies to lenders on defaulted real estate loans and crop/hail policies. For forced placed insurance, the due date for purposes of applying paragraph 2 shall be the date of billing. For TSG policies, the due date for purposes of applying paragraph 2 shall be at the expiration of the grace period given to the defaulted debtor, which is provided by statute. Crop/hail premiums are considered installment premiums in accordance with paragraph 3.b.ii. and accordingly, the due date for purposes of applying paragraph 2 shall be governed by the contractual due date of the installment.

DISCUSSION

4. The Statement of Concepts states:

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

5. Based upon the above concept, uncollected premium balances should reflect only amounts that are available to meet both current and future policyholder obligations when the obligations are due. Therefore, amounts determined to be impaired, regardless of aging, should be charged to income in the period such determination is made. Short-term policies shall also be subject to this collectibility analysis. The adoption of this methodology will more appropriately provide the statutory financial statement reader with an indication of those assets available to meet policyholder obligations. Under the conservatism concept of statutory accounting, uncollected premiums over ninety days due, even if they are determined to be collectible, should be nonadmitted and charged to surplus. Uncollected installment premiums over ninety days due, even if they are determined to be collectible, should be nonadmitted along with all future installments. Additionally, the conservatism concept of statutory accounting will not allow subsequent collection of amounts charged to surplus as nonadmitted assets to reduce the nonadmitted asset. These recoveries will be accounted for in the period received.

6. An exception to the due date guidance is provided for force placed insurance and for certain title insurance policies known as TSGs. Force placed insurance is a type of collateral protection insurance typically offered to financial institutions and other lenders that make loans secured by collateral. Coverage is obtained by the lender when the collateral securing a loan becomes uninsured by the borrower. Due to the nature of this specific type of insurance, most policies or certificates are not issued, and consequently not billed, until after the effective date of coverage. As a result, the due date for purposes of paragraph 2 is the date of billing. TSGs are title insurance policies issued to lending

institutions during the foreclosure process on defaulted real estate loans. TSGs are requested by the lending institution, and premium is booked by the reporting entity at the notice of default date. There is, typically by law, a grace period given to the defaulted debtor to bring the loan current. Since the premium is remitted to the reporting entity from the proceeds of the foreclosed property, this grace period results in a lag period before the premium could be collected. As a result, the due date for purposes of paragraph 2 is the date at which the grace period expires.

Drafting Notes/Comments

- A separate issue paper addresses deferred and uncollected life and annuity premiums.
- A separate issue paper addresses nonadmitted assets for retrospective premiums on direct or assumed business; this issue was addressed and codified by the NAIC in 1993. Guidance is included in Chapter 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies.
- A separate issue paper addresses premiums sold with recourse (premium finance company).
- Reinsurance premiums payable, reinsurance commissions receivable, etc., which are currently reported on the same line item in the Annual Statement are addressed in a separate issue paper.
- Accounting for uncollected agents' balances is addressed in Issue Paper No. 6 - Amounts Due From Agents and Brokers.
- Accounting for bills receivable is addressed in Issue Paper No. 21 - Bills Receivable For Premiums.
- Accounting/aging of retrospective premiums currently reported on line 9.2 or 9.3 is addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

7. The draft discussion material from previous Property/Casualty codification projects suggested aging of all original or renewal premiums receivable to begin as of the effective date of the policy. In addition, the proposed version suggests endorsement premiums begin aging from the effective date of the endorsement and installment premiums begin aging from the contractual due date of the installment. This presentation is consistent with GAAP and provides for a conservative aging process.
8. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 7, *Agents' Balances or Uncollected Premiums*, page 2, paragraph 2, provides the following guidance:

To satisfy the requirements of the annual statement blank, agents' balances or uncollected premiums over three months due are nonadmitted assets. (See Chapter 9 - Nonadmitted Assets, see excerpt below.)
9. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 9, *Nonadmitted Assets*, page 1, point 3, reinforces Chapter 7 by stating the following:

Agents Balances or Uncollected Premiums Over Three Months Due: The statutes of most states require that agents' balances or uncollected premiums over three months due be nonadmitted because of the uncertainty of collection.
10. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Exhibit 2 - Analysis of Nonadmitted Assets, Line 24.2 - Premiums, Agents' Balances and Installments Booked but Deferred and Not Yet Due, provides additional guidance for nonadmitting installment premiums as follows:

This item should include all future installments on all policies for which one or more installments are over three months past due.

11. The Accounting Practices and Procedures Manuals for Property and Casualty and for Life and Accident and Health Insurance Companies do not address when the aging of uncollected premiums is to commence; however, the draft discussion material from previous Property/Casualty codification projects suggested the following:

Original or deposit premiums

Aging is always based on the effective date of the policy or bond regardless of whether the insurer is using a direct billing system or an account current system.

Endorsement

Aging is always based on the effective dates of the endorsements.

Installments

Aging is always based on the due date of the installment.

12. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 18, pages 3 and 4, discusses uncollected premiums as follows:

Accident and Health Policies

Accident and health insurance policies typically provide a grace period after the due date for the premium to be received before the policy is terminated. If the company is relatively assured of collecting the late premium, and has established an appropriate unearned premium reserve, it is permitted to record such due and uncollected premium as an admitted asset.

On accident and health policies, other than group, with premiums payable more frequently than quarterly, all due and unpaid premiums are not admitted if more than one period premium is overdue. Group premiums more than 90 days overdue also are disallowed as an admitted asset.

Because the policyholder can terminate the policy at any time simply by not paying the premium, the company should consider its lapse experience in determining the amount it records as uncollected premiums. Recording older due premiums (although not more than 90 days past due), which have little or no unearned premium reserve, may overstate the company's financial condition.

Generally Accepted Accounting Principles

13. GAAP accounting for uncollectible premiums/receivables is governed by FASB Statement No. 5, *Accounting for Contingencies* (FAS 5), paragraphs 1, 3 and 8:

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss¹ (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

¹ The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

3. 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.
8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income³ if both of the following conditions are met:
- a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.⁴ It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
 - b) The amount of loss can be reasonably estimated.

³Paragraphs 23-24 of APB Opinion No. 9, *Reporting the Results of Operations*, describe the rare circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this Statement.

⁴Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.

14. The FAS-5 criteria above is used in interpreting information such as historical trending and general information about the stability of the insureds in an effort to evaluate the collectibility of the receivable balance. Accounting for contingencies is discussed in more detail in Issue Paper No. 5.

15. GAAP accounting requires the aging of direct billed premiums to begin from the effective date of the policy. Aging for endorsement premiums should begin from the endorsement's effective date and installment premiums should begin from the installment's contractual due date. Although not specifically stated, this guidance can be deduced through review of FASB Statement of Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83, as follows:

83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.
- a. Realized or realizable. Revenues and gains generally are not recognized until realized or realizable. Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

- b. **Earned.** Revenues are not recognized until earned: An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no "earning process," and for recognizing gains, being earned is generally less significant than being realized or realizable.

16. The renewal or establishment of an insurance policy in exchange for a claim to cash (premium receivable) triggers the realization characteristic of revenue recognition, therefore, the aging of the uncollected premium should commence on the effective date of the new or renewed policy. Endorsement premiums will trigger the realization characteristic on the effective date of the endorsement, while installment premiums will trigger the realization characteristic on the contractual due date of the installment.

17. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises (FAS 60)*, also provides some indirect guidance. FAS 60, paragraph 13, requires revenue on short-duration contracts to be recognized over the period of the contract in proportion to the amount of insurance protection provided. The contract period starts with the policy effective date. Therefore, it is reasonable to begin aging from the policy effective date, as this is the date when revenue recognition begins.

OTHER SOURCES OF INFORMATION

18. The draft discussion material from previous Property/Casualty codification projects proposed extensive modifications to the accounting for agents' balances and uncollected premiums. The following represents a summary of those modifications:

When the original or deposit premium is more than ninety days past due based on an aging referenced to effective date and therefore, not admitted, all premiums subsequently charged on the same policies or bonds are similarly not admitted, except that if the amount of such original or deposit premiums does not exceed 20% of the subsequently charged premiums in the same policies or bonds, such subsequently charged premiums, if otherwise not themselves more than ninety days overdue, shall be allowed as admitted assets.

19. The same basic concept was also discussed for endorsement premiums and installment premiums. In addition, it discussed certain parameters where a greater than ninety day nonadmitted premium could be accounted for as an admitted asset. The modification was stated as follows:

A premium which has been determined to be not admitted may be treated as admitted if it has been collected within forty-five days of the date of determination and not more than ninety days had elapsed from the billing date to the date of determination and further, that not more than one hundred thirty-five days had elapsed from the effective date of the premium to the date of determination.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7 & 9
- NAIC Annual Statement Instructions
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 18
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets

- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets

Generally Accepted Accounting Principles

- FASB Statement No. 5, *Accounting for Contingencies*
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Draft discussion material from previous Property/Casualty codification projects

Statutory Issue Paper No. 53

Property Casualty Contracts - Premiums

STATUS

Finalized March 16, 1998

Type of Issue:

Common Area

SUMMARY OF ISSUE

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

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

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

SUMMARY CONCLUSION

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

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

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

Disclosure Requirements

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

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

DISCUSSION

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

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

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

7. Written premiums for all other contracts shall be recorded on the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Unearned premium reserve meets the definition of a liability as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5).
8. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of property and casualty contracts shall be recognized in the statement of operations, as earned premium, using either the daily pro-rata or monthly pro-rata methods as described in paragraph 17. Certain issue papers provide for different methods of recognizing premium in the statement of operations for specific types of contracts. For contracts not separately identified in specific issue papers where the reporting entity can demonstrate the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.
9. Additional premiums that are charged to policyholders for endorsements and for changes in coverage under the contract shall be recorded on the effective date of the endorsement and accounted for in a manner consistent with the methods discussed in paragraphs 7 and 8 so that at any point in time a liability is accrued for unearned premium equal to the premium amount charged for the unexpired portion of the policy endorsement.
10. Adjustments to the amount of premium charged for changes in the level of exposure to insurance risk (such as audit premiums on workers' compensation policies) are generally determined based upon audits conducted after the policy has expired. Reporting entities shall estimate audit premiums, the amount generally referred to as earned but unbilled (EBUB) premium, and shall record such amounts as an adjustment to premium, either through written premium or as an adjustment to earned premium. Such amounts meet the definition of assets as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. Such amounts shall be adjusted upon completion of the audit and the adjustment shall be recognized as revenue immediately. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using company historical unearned premium data, or per policy calculations. Upon completion of an audit that results in a return of premiums to the policyholder, earned premiums shall be reduced. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis, must be reported in the annual statement as a nonadmitted asset, however, to the extent that amounts in excess of the 10% are not anticipated to be collected they shall be written off against operations in the period the determination is made. Reporting entities shall establish all of the requisite liabilities associated with the asset such as commissions and premium taxes.
11. When the anticipated losses, loss adjustment expenses commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each such grouping where a premium deficiency is indicated. Such deficiencies shall not be offset by anticipated profits in other policy groupings. If an reporting entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the notes to the financial statements.

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

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

Drafting Notes/Comments

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

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

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

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

Direct Premiums

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

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

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

Assumed and Ceded Reinsurance Premiums

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

Net Written Premiums

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

Earned Premiums

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

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

Earned But Unbilled Premiums

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

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

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

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

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

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

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

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

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

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

Audited Policies

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

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

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

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

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

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

Generally Accepted Accounting Principles

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

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

b. Determination of the Due Date -

- i. The due date for original and deposit premiums is governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship.
- ii. The due date for endorsement and installment premiums is governed by the effective date of the endorsement and the contractual due date of the installment.
- iii. The due date for audit premiums and retrospective premiums is governed by policy provisions or contract provisions. If the due date for receivables relating to audits is not addressed by policy provisions or contract provisions, any uncollected premium (either accrued or billed) is nonadmitted.
- iv. These provisions are to be applied to all premium receivables except those arising from force placed insurance obtained by a lender for collateral protection, certain policies, known as a Trustee Sales Guarantees (TSGs), issued by title insurance companies to lenders on defaulted real estate loans and crop/hail policies. For forced placed insurance, the due date for purposes of applying paragraph 2 shall be the date of billing. For TSG policies, the due date for purposes of applying paragraph 2 shall be at the expiration of the grace period given to the defaulted debtor, which is provided by statute. Crop/hail premiums are considered installment premiums in accordance with paragraph 3.b.ii. and accordingly, the due date for purposes of applying paragraph 2 shall be governed by the contractual due date of the installment.

DISCUSSION

4. The Statement of Concepts states:

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

5. Based upon the above concept, uncollected premium balances should reflect only amounts that are available to meet both current and future policyholder obligations when the obligations are due. Therefore, amounts determined to be impaired, regardless of aging, should be charged to income in the period such determination is made. Short-term policies shall also be subject to this collectibility analysis. The adoption of this methodology will more appropriately provide the statutory financial statement reader with an indication of those assets available to meet policyholder obligations. Under the conservatism concept of statutory accounting, uncollected premiums over ninety days due, even if they are determined to be collectible, should be nonadmitted and charged to surplus. Uncollected installment premiums over ninety days due, even if they are determined to be collectible, should be nonadmitted along with all future installments. Additionally, the conservatism concept of statutory accounting will not allow subsequent collection of amounts charged to surplus as nonadmitted assets to reduce the nonadmitted asset. These recoveries will be accounted for in the period received.

6. An exception to the due date guidance is provided for force placed insurance and for certain title insurance policies known as TSGs. Force placed insurance is a type of collateral protection insurance typically offered to financial institutions and other lenders that make loans secured by collateral. Coverage is obtained by the lender when the collateral securing a loan becomes uninsured by the borrower. Due to the nature of this specific type of insurance, most policies or certificates are not issued, and consequently not billed, until after the effective date of coverage. As a result, the due date for purposes of paragraph 2 is the date of billing. TSGs are title insurance policies issued to lending

institutions during the foreclosure process on defaulted real estate loans. TSGs are requested by the lending institution, and premium is booked by the reporting entity at the notice of default date. There is, typically by law, a grace period given to the defaulted debtor to bring the loan current. Since the premium is remitted to the reporting entity from the proceeds of the foreclosed property, this grace period results in a lag period before the premium could be collected. As a result, the due date for purposes of paragraph 2 is the date at which the grace period expires.

Drafting Notes/Comments

- A separate issue paper addresses deferred and uncollected life and annuity premiums.
- A separate issue paper addresses nonadmitted assets for retrospective premiums on direct or assumed business; this issue was addressed and codified by the NAIC in 1993. Guidance is included in Chapter 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies.
- A separate issue paper addresses premiums sold with recourse (premium finance company).
- Reinsurance premiums payable, reinsurance commissions receivable, etc., which are currently reported on the same line item in the Annual Statement are addressed in a separate issue paper.
- Accounting for uncollected agents' balances is addressed in Issue Paper No. 6 - Amounts Due From Agents and Brokers.
- Accounting for bills receivable is addressed in Issue Paper No. 21 - Bills Receivable For Premiums.
- Accounting/aging of retrospective premiums currently reported on line 9.2 or 9.3 is addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

7. The draft discussion material from previous Property/Casualty codification projects suggested aging of all original or renewal premiums receivable to begin as of the effective date of the policy. In addition, the proposed version suggests endorsement premiums begin aging from the effective date of the endorsement and installment premiums begin aging from the contractual due date of the installment. This presentation is consistent with GAAP and provides for a conservative aging process.
8. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 7, *Agents' Balances or Uncollected Premiums*, page 2, paragraph 2, provides the following guidance:

To satisfy the requirements of the annual statement blank, agents' balances or uncollected premiums over three months due are nonadmitted assets. (See Chapter 9 - Nonadmitted Assets, see excerpt below.)
9. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 9, *Nonadmitted Assets*, page 1, point 3, reinforces Chapter 7 by stating the following:

Agents Balances or Uncollected Premiums Over Three Months Due: The statutes of most states require that agents' balances or uncollected premiums over three months due be nonadmitted because of the uncertainty of collection.
10. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Exhibit 2 - Analysis of Nonadmitted Assets, Line 24.2 - Premiums, Agents' Balances and Installments Booked but Deferred and Not Yet Due, provides additional guidance for nonadmitting installment premiums as follows:

This item should include all future installments on all policies for which one or more installments are over three months past due.

11. The Accounting Practices and Procedures Manuals for Property and Casualty and for Life and Accident and Health Insurance Companies do not address when the aging of uncollected premiums is to commence; however, the draft discussion material from previous Property/Casualty codification projects suggested the following:

Original or deposit premiums

Aging is always based on the effective date of the policy or bond regardless of whether the insurer is using a direct billing system or an account current system.

Endorsement

Aging is always based on the effective dates of the endorsements.

Installments

Aging is always based on the due date of the installment.

12. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 18, pages 3 and 4, discusses uncollected premiums as follows:

Accident and Health Policies

Accident and health insurance policies typically provide a grace period after the due date for the premium to be received before the policy is terminated. If the company is relatively assured of collecting the late premium, and has established an appropriate unearned premium reserve, it is permitted to record such due and uncollected premium as an admitted asset.

On accident and health policies, other than group, with premiums payable more frequently than quarterly, all due and unpaid premiums are not admitted if more than one period premium is overdue. Group premiums more than 90 days overdue also are disallowed as an admitted asset.

Because the policyholder can terminate the policy at any time simply by not paying the premium, the company should consider its lapse experience in determining the amount it records as uncollected premiums. Recording older due premiums (although not more than 90 days past due), which have little or no unearned premium reserve, may overstate the company's financial condition.

Generally Accepted Accounting Principles

13: GAAP accounting for uncollectible premiums/receivables is governed by FASB Statement No. 5, *Accounting for Contingencies* (FAS 5), paragraphs 1, 3 and 8:

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss¹ (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

¹ The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

3. 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.
8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income³ if both of the following conditions are met:
- a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.⁴ It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
 - b) The amount of loss can be reasonably estimated.

³Paragraphs 23-24 of APB Opinion No. 9, Reporting the Results of Operations, describe the rare circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this Statement.

⁴Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.

14. The FAS 5 criteria above is used in interpreting information such as historical trending and general information about the stability of the insureds in an effort to evaluate the collectibility of the receivable balance. Accounting for contingencies is discussed in more detail in Issue Paper No. 5.

15. GAAP accounting requires the aging of direct billed premiums to begin from the effective date of the policy. Aging for endorsement premiums should begin from the endorsement's effective date and installment premiums should begin from the installment's contractual due date. Although not specifically stated, this guidance can be deduced through review of FASB Statement of Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83, as follows:

83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.
- a. Realized or realizable. Revenues and gains generally are not recognized until realized or realizable. Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

- b. Earned. Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no "earning process," and for recognizing gains, being earned is generally less significant than being realized or realizable.

16. The renewal or establishment of an insurance policy in exchange for a claim to cash (premium receivable) triggers the realization characteristic of revenue recognition, therefore, the aging of the uncollected premium should commence on the effective date of the new or renewed policy. Endorsement premiums will trigger the realization characteristic on the effective date of the endorsement, while installment premiums will trigger the realization characteristic on the contractual due date of the installment.

17. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (FAS 60), also provides some indirect guidance. FAS 60, paragraph 13, requires revenue on short-duration contracts to be recognized over the period of the contract in proportion to the amount of insurance protection provided. The contract period starts with the policy effective date. Therefore, it is reasonable to begin aging from the policy effective date, as this is the date when revenue recognition begins.

OTHER SOURCES OF INFORMATION

18. The draft discussion material from previous Property/Casualty codification projects proposed extensive modifications to the accounting for agents' balances and uncollected premiums. The following represents a summary of those modifications:

When the original or deposit premium is more than ninety days past due based on an aging referenced to effective date and therefore, not admitted, all premiums subsequently charged on the same policies or bonds are similarly not admitted, except that if the amount of such original or deposit premiums does not exceed 20% of the subsequently charged premiums in the same policies or bonds, such subsequently charged premiums, if otherwise not themselves more than ninety days overdue, shall be allowed as admitted assets.

19. The same basic concept was also discussed for endorsement premiums and installment premiums. In addition, it discussed certain parameters where a greater than ninety day nonadmitted premium could be accounted for as an admitted asset. The modification was stated as follows:

A premium which has been determined to be not admitted may be treated as admitted if it has been collected within forty-five days of the date of determination and not more than ninety days had elapsed from the billing date to the date of determination and further, that not more than one hundred thirty-five days had elapsed from the effective date of the premium to the date of determination.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7 & 9
- NAIC Annual Statement Instructions
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 18
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets

- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets

Generally Accepted Accounting Principles

- FASB Statement No. 5, *Accounting for Contingencies*
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Draft discussion material from previous Property/Casualty codification projects

Statutory Issue Paper No. 53

Property Casualty Contracts - Premiums

STATUS

Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

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

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

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

SUMMARY CONCLUSION

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

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

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

7. Written premiums for all other contracts shall be recorded on the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Unearned premium reserve meets the definition of a liability as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5).
8. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of property and casualty contracts shall be recognized in the statement of operations, as earned premium, using either the daily pro-rata or monthly pro-rata methods as described in paragraph 17. Certain issue papers provide for different methods of recognizing premium in the statement of operations for specific types of contracts. For contracts not separately identified in specific issue papers where the reporting entity can demonstrate the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.
9. Additional premiums that are charged to policyholders for endorsements and for changes in coverage under the contract shall be recorded on the effective date of the endorsement and accounted for in a manner consistent with the methods discussed in paragraphs 7 and 8 so that at any point in time a liability is accrued for unearned premium equal to the premium amount charged for the unexpired portion of the policy endorsement.
10. Adjustments to the amount of premium charged for changes in the level of exposure to insurance risk (such as audit premiums on workers' compensation policies) are generally determined based upon audits conducted after the policy has expired. Reporting entities shall estimate audit premiums, the amount generally referred to as earned but unbilled (EBUB) premium, and shall record such amounts as an adjustment to premium, either through written premium or as an adjustment to earned premium. Such amounts meet the definition of assets as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. Such amounts shall be adjusted upon completion of the audit and the adjustment shall be recognized as revenue immediately. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using company historical unearned premium data, or per policy calculations. Upon completion of an audit that results in a return of premiums to the policyholder, earned premiums shall be reduced. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis, must be reported in the annual statement as a nonadmitted asset, however, to the extent that amounts in excess of the 10% are not anticipated to be collected they shall be written off against operations in the period the determination is made. Reporting entities shall establish all of the requisite liabilities associated with the asset such as commissions and premium taxes.
11. When the anticipated losses, loss adjustment expenses commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each such grouping where a premium deficiency is indicated. Such deficiencies shall not be offset by anticipated profits in other policy groupings. If an reporting entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the notes to the financial statements.

Disclosure Requirements

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

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

DISCUSSION

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

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

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

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

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

Drafting Notes/Comments

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

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

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

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

Direct Premiums

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

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

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

Assumed and Ceded Reinsurance Premiums

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

Net Written Premiums

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

Earned Premiums

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

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

Earned But Unbilled Premiums

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

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

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

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

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

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

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

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

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

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

Audited Policies

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

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

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

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

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

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

Generally Accepted Accounting Principles

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

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

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

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

Premium Revenue Recognition

Short-Duration Contracts

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

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

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

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

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

Revenue Recognition

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

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

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

RELEVANT LITERATURE

Statutory Accounting

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

Generally Accepted Accounting Principles

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

State Regulations

- No further guidance obtained from state statutes or regulations.