ACCOUNTING ISSUES AND UNDERWRITING: A ROUGH GUIDE

By Roy Katzenberg

1 Introduction

Insurers often have to consider accounting information, whether it is provided at the placing stage, or at the claims assessment stage. Accounting is a large discipline with many complex facets and this paper highlights the issues that could face an underwriter dealing with accounting matters, such as insurance policies which involve:

- property / fire insurance
- business interruption policies e.g. political risk, fire policies
- complex whole account covers or balance sheet protection policies e.g. ART policies.

This paper will :

- set out when accounting information from the insured may be needed or available;
- explain what could be meant by the simple term, "accounts";
- explain what is contained in "accounts", how and the purposes for which they are prepared, and the bases upon which they could be drawn up;
- give examples of misunderstandings; and
- provide some practical suggestions to avoid misunderstandings.

2 Accounting Information From The Insured

The underwriter requests appropriate information to assess the risk and this is usually done by issuing tailored proposal forms, for example, a request to attach financial statements. The proposer will provide a response for the underwriter to review. Often financial information is requested from the proposer, and "accounts" will be provided. Is the underwriter comfortable that the information he has been provided is that which he expected to see? Is it relevant, and is it at the correct level of detail?

Some types of claims will be based on financial information, for example, business interruption claims, and an understanding of the information provided will be relevant to the proper adjustment of the claim.

3 What Is Meant By The Term "Accounts"?

The first difficulty arises in simply understanding the different types of accounting information and knowing what it might be called. Some definitions are set out in the table below:

Term	Definition
Accounts	There is no strict definition, but it is likely to mean the balance sheet, profit and loss account (also referred to as the Income Statement), and perhaps the cash flow statement
[Annual] Financial Statements or "annual accounts"	This usually refers to the accounts together with the notes to the accounts prepared for statutory purposes. Comparative figures (i.e. prior year figures) will be shown
Annual report and accounts	In the UK this refers to Audited Annual Financial statements (see above) together with the directors' report, chairman's statement and any other information which the company wishes to include.
Management accounts	Various types of unaudited financial information including a balance sheet and income statement prepared for internal purposes. However, the financial information may be drawn up on a different basis to that included in the annual report and accounts and may not be consistent with them. Comparative figures may be provided, as may a budget and variances from the budget.

4 The Content Of "Accounts"

Non-financial information

The annual report and accounts contains details of the names of the directors and management, the location of the business, trading with associated parties, investments held, group companies and other relationships. These details are contained in notes to the accounts or in the directors' report, chairman's report, divisional reviews, or, as it is called in US SEC statements, the Management Discussion.

The audit report

In the United Kingdom auditors are required by law to form an opinion on the financial statements of the company / group. Many more UK companies are audited than corporations in other jurisdictions. The audit report will specify the information on which their opinion is based, usually by simply stating the page numbers where that information can be found. Their report does not cover the directors' report although auditors are obliged to report if it contains inconsistencies between the financial statements and the directors' report.

An unqualified or "clean" audit opinion means that the auditor finds that the financial statements fairly present the information without exception. A qualified report indicates that there is an exception. Disputes noted in the audit report should be viewed with extra caution as disagreements in accounting treatment, appropriateness of accounting policies will be described in the audit report. Consider the following example of an audit report with an "adverse opinion":

> *As more fully explained in note X, no provision has been made for losses expected to arise on certain long term contracts currently in progress, as the directors consider that such losses should be offset against amounts receivable on other long term contracts. In our opinion, provision should be made for foreseeable losses on individual contracts as required by Statement of Standard Accounting Practice 9. If losses had been so recognised the effect would have been to reduce the profit before and after tax for the year and the contract work in progress at 31 December 1999 by £......*
>
> *In view of the effect of the failure to provide for losses referred to above, in our opinion the financial statements do not give a true and fair view of the state of the company's affairs at 31 December 1999 and of its profit [loss] for the year then ended. In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Companies Act 1985.*

There is a category of audit comment between "clean" and qualified, where auditors draw attention to an issue that is fundamental to the reader's understanding of the accounts, but where the auditor does not disagree with the treatment adopted in the accounts. For example, if the company was dependent upon the success of a single project, and there were concerns that the project may not be completed, it would be common for this to be noted and drawn to the reader's attention. A recent example in the insurance industry is financial statements of syndicates prepared just before the Lloyd's Reconstruction and Renewal process was completed. The audit report drew the reader's attention to the uncertainties surrounding the project and alerted them to take care in evaluating the results of the earlier years.

Consolidated or single entity financial statements

Consolidated financial statements are those where the balance sheets and profit and loss accounts of all the companies in the group have been aggregated together. Single entity financial statements are those of one company only. The rules for when consolidation is required are complex and change from time to time. Holding companies in the UK that are obliged to prepare consolidated financial statements will present a consolidated balance sheet, a single entity balance sheet, and a consolidated profit and loss account. They are not required to present a single entity profit and loss account, although the details can often be found in the notes (see below).

Cash flow statements

Cash flow statements contain details of the cash inflows and outflows over the past reporting period.

The notes to the accounts

The balance sheet, a profit and loss and a cash flow statement are often simplified with the details contained in notes which may run to 10 or 20 pages. A key note is the one (usually the first) which provides an explanation as to the basis of preparation of the Accounting Policies.

Choice of accounting policies

The choice of accounting policies is made by the management, who are responsible for the preparation of financial statements. The choice of the most appropriate accounting policies can in some cases be subjective, and there can be significant differences in the results between different policies. Importantly, inclusion in the notes to the accounts does ensure that the auditor expresses an opinion on the appropriateness of the policies adopted by the company.

Accounting conventions and Generally Accepted Accounting Practice ("GAAP")

Underwriters should be aware that there are specific accounting conventions for different countries and different industries, for example, Ernst & Young have produced a 2000 page discussion on UK GAAP, there is a body of international accounting standards, and extensive guidance on US GAAP. Certain general rules that are prescribed do not work in all circumstances, and are modified to take into account the needs of the industry. Informal guidance and uncodified practices exist. The rules themselves are constantly being developed for new circumstances and there is normally a lead in time for them to be adopted. Quite often the information required to comply with a rule may require a change of accounting systems, hence the lead in period. The underwriter should be aware of which accounting practice has been used and how industry specific issues have been dealt with.

Discrepancies between UK and German practice fell under the spotlight last year when losses at subsidiary Rover were cited as the reason for BMW's threat to stop building cars at the Rover Longbridge plant. Rover's accounts, compiled under UK GAAP and filed at Companies House, showed it made profits of £147m between 1994 and 1997. BMW's consolidated accounts prepared following German standards showed Rover making a loss of £363m in the same period. The different figures arise mainly as a result of differences in UK and German methods of accounting for depreciation. (Accountancy Age 24/2/00)

Accounting Policies and the basis of preparation

The accounting policies will explain how the financial statements are prepared:

- Usually the accounts will be prepared on the historical cost basis, which implies that the values in the financial statement contain the amounts the company has paid or has to pay for the items in the financial statements. An alternative basis is the current cost basis, indicating the current cost of items in the financial statements, though this is only likely to be applied in hyperinflationary economies or in utilities where there is a link to regulated price controls.
- Normally, items with a value to the business less than the historic cost will be written down, for example, goods for resale where the sales price has fallen below cost will be shown at net realisable value.
- Fixed assets are generally written off (described as "depreciated" or "amortised") over the period of use and the periods will be disclosed. The land on which buildings stand is not depreciated.
- In most instances company accounts are prepared on the accruals basis, which means that the financial statements will include all the transactions completed in cash as well as the items to be paid and received, that is, the debtors and creditors. Certain organisations, principally government organisations, account on the cash basis. The cash basis reports the results of cash transactions only, and ignores items yet to be paid or received, like debtors and creditors. The accruals basis is preferable as it will disclose a more accurate position.
- The accounts are prepared on the "going concern" basis, which assumes that the business will continue for the foreseeable future - usually 12 months from the date of signing. This means that the assets will be valued in accordance with the normal accounting policies adopted by the business. If the going concern basis was not appropriate the assets would be valued at the amounts they would be expected to

realise for example, on a forced sale or break up basis, and provision would also be made for closure costs.

- Accountants are conservative and accounts will be prepared on a conservative or prudent basis. Consider the following matrix for recognition of assets and liabilities:

Likelihood of outcome	**Accounting treatment of contingent liabilities**	**Accounting treatment of contingent assets**
Virtually certain (>95% probable)	Recognise as a liability	Recognise as asset
Probable - (50-95% probable)	Not a contingent liability therefore provide	Disclose (but do not include in the company's assets)
Possible, but not probable (5-50% probable)	Disclose	No disclosure permitted
Remote (<5% probable)	No disclosure under accounting statements, but may be required by UK Companies Act	No disclosure permitted

*A contingent liability is

a a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control; or

b a present obligation that arises from past events but is not recognised because:

i) it is not probable that a transfer of economic benefits will be required to settle the obligation; or

ii) the amount of the obligation cannot be measured with sufficient reliability.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control.

- Normally in the UK and USA if an asset which has been written down regains its value it can be revalued up to cost.

Revenue recognition

Consider the position of a manufacturer of large machinery who manufactures for order. When should he recognise the sale? Does he recognise the sale when the machinery is substantially manufactured, when it is completely manufactured, when it is segregated for delivery, when it is delivered to the customer, or when the customer has paid for it? In the absence of specific agreement, it is normal to recognise the sale and the associated debtor when the machinery is delivered to the customer, and earlier or later recognition of income could suggest a business that is massaging its results. Changes in the way revenue is recognised should be disclosed and should be viewed with caution. If the directors wished to advance profit and turnover recognition, they could move from recognising sales on delivery to recognising sales on manufacture or on order which could be even earlier.

Other contents of notes to the financial statements

The notes should also contain details of contingent liabilities, for example, a reference to a disputed claim. The last thing the drafter of a contingent liability note will want to do is indicate that the company has a weak position in regard to the contingency. He will not suggest an unfavourable outcome, because if that is the case, it should have been recognised as a liability and the other party to the dispute will seize upon the admission. The contingent liability notes are therefore often carefully worded, often very short, and unless care is taken they could be overlooked.

> *Extract from British American Tobacco plc (1998) ...... Conclusion*
> *While it is impossible to be certain of the outcome of any particular case or of the amount of any possible adverse verdict, the Company believes that the defences of the Group companies to all these various claims are meritorious both on the law and the facts, and a vigorous defence is being made everywhere. If an adverse judgement were entered against any of the Group companies in any case, an appeal would be made. Such appeals could require the posting of appeal bonds or substitute security by the appellants for the amounts of such adverse judgements; at least in the aggregate and despite the quality of defences available to the Group, it is not impossible that the results of operations or cash flows of the Group in particular quarterly or annual periods could be materially affected by this and by the final outcome of the larger litigation.*
> *Having regard to all these matters, the Directors (i) do not consider it appropriate to make any provision in respect of any pending litigation and (ii) do not believe that the ultimate outcome of all this litigation will significantly impair the financial condition of the Group.*

Format of accounts

Accounts are often prepared in a consistent format although the formats vary between jurisdictions. For example, the "bottom line" on a US GAAP balance sheet shows total assets or total liabilities, and current liabilities are not offset against current assets. In UK GAAP the current liabilities are set off against current assets, and the bottom line is a total of fixed and other assets, and net current assets. A US GAAP presentation would show a higher bottom line and could imply that the company was larger, or the insured assets were larger. This is set out below:

		Presentation	
		UK	USA
Fixed assets		1,000	1,000
Investments		500	500
Current assets			
Stocks	300		300
Debtors	1,000		1,000
Cash	200		200
Current liabilities			
Creditors	(1,100)		
Net current assets		400	
Balance sheet total		1,900	3,000
Owner's equity		(1,900)	(1,900)
Creditors			(1,100)
Balance sheet total		(1,900)	(3,000)

Contents of management accounts

Management accounts usually do not include notes. There may be a presumption that the management accounts will have been prepared using the same bases as those adopted by the company for preparing the annual financial statements, but this is not always the case and it may be necessary to make enquires to ascertain the basis. Management accounts are prepared to enable the management to react rapidly to changing circumstances and accuracy may have been sacrificed by the use of preliminary figures and estimates. There could be significant adjustments when the annual financial statements are prepared as there has been more time for reflection, a process of checking has occurred, and some time has elapsed which may have allowed issues to crystallise.

The author has audited a holding company where consolidated financial statements were required to be produced. A subsidiary had completed and filed its annual report and accounts a month after year end, and by the time the consolidated annual report and accounts were being prepared two months later a debtor of the subsidiary had failed. A provision was made in the consolidated financial statements for the uncollectable amount.

Management accounts are sometimes prepared on a local accounting basis, or a basis upon which management are measured, and these bases may be different from those adopted for the annual financial statements. For example, management may be measured on the results of operations before interest, foreign exchange differences and tax. The interest and foreign exchange differences may be recorded in a movement of shareholders' funds in a note to the balance sheet, rather than in the profit and loss account. It is therefore important to understand the basis of preparation of management accounts.

Management accounts often include a prospective cash flow, a comparison to budget, and a forecast profit and loss account until the end of the period. The forecasts are prepared for the purpose of managing the business and there is no guarantee that they will be accurate. Annual forecasts are often prepared a few months prior to the beginning of the year and they may or may not be updated. An updated forecast should be more accurate but may give an impression that the management has a better understanding and control of the business. There is no fixed format for management accounts, and care should be taken to ensure that the appropriate information is used for the underwriting decision.

Reduced Disclosure requirements

The disclosure requirements for smaller non-listed companies are less onerous than for larger ones, and in the UK small companies can file "abbreviated accounts". These contain significantly less information, for example, they may not show the sales.

The writer has seen US financial statements for non-listed corporations, which do not have full SEC disclosure. The first page of these financial statements was the auditors' report, referred to by underwriters as the Auditors' report, as if it was a report specially commissioned from the auditors to back up the claim made by the insured.

Two or more sets of "accounts"

Companies sometimes prepare two or more sets of financial information. For example, annual financial statements may be prepared in local GAAP for local filing purposes, and another set for filing in the parent company jurisdiction in another GAAP.

Financial information may be required for local tax purposes in accordance with rules for the presentation and valuation promulgated by the authorities.

The underwriter needs to understand which set of "accounts" has been presented to him by asking appropriate questions and if necessary, checking with an accountant.

Information purportedly from financial statements

It is conceivable that the underwriter is not provided with the full set of financial statements, but a schedule of the assets to be insured. He should consider whether it is necessary to obtain appropriate analyses or financial information from the proposer which will allow him to establish that assets values are included in the financial statements and the value at which they are recorded, for example, by obtaining a breakdown of the total assets in the financial statements, such breakdown to identify the insured assets.

5 Some Examples Of Misunderstandings

Goodwill

Goodwill is an accounting term for the excess of purchase price paid over the fair values of the net assets acquired when one company acquires another. For example, an acquirer of an internet company will probably find that he has acquired some computer and office equipment for far less than was paid for the business. The difference represents Goodwill.

Amount paid for business	100
Less: Fixed and other assets acquired	(10)
Goodwill	90

Goodwill was usually written off immediately in the UK, but written off over 20 years in the USA. Recently the USA approach has been adopted in the UK, but the net asset value of acquisitive companies could differ materially between USA and UK financial statements. There are insurance products available that give cover for the net asset value of businesses for which these types of issues are particularly relevant.

Long Term Contracts

Contracts to build a factory, ship, facility, etc., often extend over more than one year and are referred to as long term contracts. The costs associated with long term contracts are collected on the balance sheet. The company must decide if it will recognise profits over the term of the contract or on its completion. If it recognises profits during the term, the balance sheet value of the contract will contain an element of profit relating to the contract and would therefore have a higher book value than those in a company that recognises profit at the end of the contract.

Investment property

Investment Property must be revalued in the UK but this might not be allowed in other jurisdictions where the property must be depreciated over its useful life.

Hidden Reserves

Some jurisdictions allow provision accounting which stated simply allows companies to have "rainy day" funds or "hidden reserves" which can be used to "smooth" results in the event of a bad year. These funds are included somewhere on the balance sheet. The existence and use of such funds may be important to the underwriter's decision, as the utilisation of "hidden reserves" may give an impression of a more profitable entity that is a lower insurance risk. "Rainy day" funds are different in concept to an insurance IBNR reserve, which should represent an allowance for expected claims development, rather than a "pot of funds" to be used to smooth earnings.

In the United Kingdom when providing for restructuring it was possible to classify all kinds of operating costs as restructuring costs, and thereby invite the reader to perceive them in a different light from "normal" costs of operating in a dynamic business environment. The rules were tightened recently. De La Rue Plc provides an example of a group that has had to restate the accounts of earlier years to alter the timing of recognition of such costs in conformity with the new rules.

> *Extract De La Rue plc 1999*
> *Note 29 - Prior Year adjustment*
> *The implementation of new accounting standards has resulted in a number of prior year adjustments:*
> *(a) The reorganisation costs of £14.8m in respect of Security Paper and Print which was previously charged in 1996/97 has been recharged in 1997/98...*

Research expenditure

Pure Research in a manufacturing company is normally expensed as incurred, while prospecting expenditure in respect of on-going projects in an exploration company is usually carried on the balance sheet. Prospecting expenditure may be accumulated until the mine or oil well is producing, in which case the expenditure will be amortised over the life of the mine. It is also normal to consider the life of the mine or oil well and take an early charge if the full cost cannot be recovered. It would be management's responsibility to undertake these reviews. These reviews may only occur periodically and there is no certainty that a review would have been conducted and the effects recorded in each set of management accounts.

Stock in Trade

The same stocks could be valued on two different bases. Stocks held by companies who trade on commodity exchanges are often valued at a "mark-to-market" price, while the same stocks held by manufacturers are usually held at the lower of cost or net realisable value. The mark-to-market price could include an unrealised gain and be higher than cost.

Cash Flow Issues

A comparison of the cash flow with the profit may yield valuable results, as a lower cash flow than profit could be a cause for concern as it may imply that there is some difficulty in realising the profits in cash. For example, a large profit, and a corresponding increase in debtors could meant that :

- large sales occurred at the end of the period;
- overtrading;
- false sales were booked to bolster results;
- there is a dispute between the company and its customer and the customer is not paying; or

a combination of all or some of these.

6 Some Practical Suggestions To Avoid Misunderstandings

In the light of the foregoing, which identify just some of the complexities of accounting, it is worth giving some consideration to relatively straightforward ways for ensuring that there are no misunderstandings when the insurer is presented with the information he needs to made a decision.

Obtain relevant financial information

The latest audited annual report and accounts should be obtained and checked to see if they are current. In the UK listed companies are required to file their annual report and accounts at Companies House within six months of the end of the accounting period, non-listed PLC companies within seven months and non listed private companies within ten months. For example, if the underwriter requests accounts from a non-listed private company in September 2000, he might find that the latest available Annual Report and Accounts of company with a December year end may be those of December 1998, i.e. 21 months old.

If the annual report and accounts are not current, a combination of latest annual report and accounts, and latest management "accounts" should be used and a check made to understand the basis of preparation of the management accounts. Procedures should be in place to ensure that relevant information has been received and understood, and has been considered with the proposed policy wordings.

If the insurance is to be based on a prospective position or budgetary information, the underwriter should obtain details of the budgets and make enquiries as to the basis of preparation, compare the budgets with previous financial statements, accounting policies, etc. to be able to see if the risk is reasonably presented.

Break the barrier of terminology

Language and cultural differences may create circumstances where the proposer has provided information pursuant to an underwriter request, but the information does not fulfil the requirements of the underwriter. This is not a question of concealment, but merely a misunderstanding between the request and the response. The underwriter should review the information to see if it meets with the proposal requirements. In the event of any doubt, he should consider obtaining expert accounting advice to interpret the financial data provided and determine if the data provided was relevant and reasonable.

Should the information be checked in more detail?

Should the underwriter consider making or commissioning a visit to the insured to verify the information? The writer is aware of some underwriters' views that they would in some circumstances rather put the business on their books, relying on the duty of the insured to provide all material facts. If a review is subsequently commissioned and adverse material facts come to light, the underwriter will have the option of cancelling the policy. However, this approach may not enable an underwriter to escape from a policy where the relevant information was not requested as a result of the underwriter's misunderstandings. He will then have to wait until renewal to decline to continue to insure the risk.

Peruse the entire financial statements

It is worthwhile studying the financial statements in their entirety to discover any relationships that may exist between the financial information and the other information, for example, relationships between related parties.

Response to deal with the delay factor in soft markets

Underwriters are understandably reluctant to do anything that may discourage the broker or proposer from giving them the business in soft markets. When faced with a proposal that appears to the underwriter to require further explanation, he can:

- investigate the proposal in more detail, with the attendant risk that the business may go to another underwriter who asks less questions;
- take on the business and then investigate the risk in more detail, e.g. commission a review of the financial information. Should anything come to light the underwriter has the option, depending on its seriousness, of terminating the cover, continuing and negotiating a higher price at renewal, or doing nothing; or
- take on the business and doing nothing further, relying on the duties of disclosure and utmost good faith to protect him.

The underwriter may not be able to rely on the general duties of good faith and disclosure if the required information was provided to him but its significance was not realised at the time.

Conclusion

This paper has highlighted the need to obtain the most relevant financial information. It has discussed the complexities of the simple term "accounts" and highlighted the need for a careful review and understanding of the information provided for relevance to the underwriting/claims assessment decision.

Some of the issues may not be apparent to non-accountants, and it may be worthwhile obtaining advice in circumstances where the accounting information is critical.

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