1. Expenses involved in acquiring and underwriting policies and servicing policyholders and third-party claimants are important elements of a reporting entity's operations. Uniformity in the classification, allocation and reporting of expenses and expense statistics by reporting entities within the same industry is critical in a regulatory environment and is consistent with both the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) and the FASB Statements of Financial Accounting Concepts (GAAP Statement of Concepts). Such uniformity is necessary for the effective review of operations of a specific entity, comparisons across the industry and control/regulation of the industry.

2. Current statutory accounting is outlined in the Accounting Practices and Procedures Manuals for Property and Casualty and for Life and Accident and Health Insurance Companies (P&C Accounting Practices and Procedures Manual and Life/A&H Accounting Practices and Procedures Manual) and in the NAIC Annual Statement Instructions (Annual Statement Instructions).

3. This issue paper establishes rules on presentation and allocation of certain expenses of reporting entities into general categories and the apportionment of shared expenses between members of a group of companies. The scope of this issue paper is limited to the general categories. Disclosure in notes or exhibits to the financial statements is required for principal components of those categories.

4. This paper establishes uniform expense allocation rules to classify expenses within prescribed principal groupings. It is necessary to allocate those expenses which may contain characteristics of more than one classification, which this issue paper will refer to as allocable expenses.

5. Allocable expenses for property and casualty insurance companies shall be classified into one of three categories on the Underwriting and Investment Exhibit as follows:

- Loss adjustment expenses - Expenses incurred in the adjusting, recording and paying of claims (including expenses associated with commutations).

- Investment expenses - Expenses incurred in the investing of funds and pursuit of investment income. Such expenses include those specifically identifiable and allocated costs related to activities such as initiating and handling orders, researching and recommending investments (i.e., investment strategy), appraising, valuing, disbursing funds and collecting income, securities safekeeping, real estate taxes, records maintenance, data processing, support personnel, postage and supplies, office overhead, management and executive duties and all other functions reasonably associated with the investment of funds.

- Other underwriting expenses - Allocable expenses other than loss expenses and investment related expenses.

6. Similarly for life and accident and health insurers allocable expenses shall be categorized as general insurance expenses; insurance taxes, licenses and fees; or investment expenses which are netted against investment income on the Summary of Operations.

7. Allocation to the above categories should be based on a method that yields the most accurate results. Specific identification of an expense with an activity that is represented by one of the categories above will generally be the most accurate method. Where specific identification is not feasible allocation of expenses should be based upon pertinent factors or ratios such as studies of employee activities, salary ratios or similar analyses.

8. Allocation may be entirely to one expense category based upon the type of expense incurred, for example, premium taxes would be 100% allocated to Other Underwriting Expenses for property and casualty companies. Other expenses may be allocated across several categories, such as salaries, which may be allocated to both general insurance expenses and net investment income of a life and accident and health company.

9. Many entities operate within a group where personnel and facilities are shared. Shared expenses, including expenses under the terms of a management contract, shall be apportioned to the entities incurring the expense as if the expense had been paid solely by the incurring entity. The apportionment shall be completed based upon specific identification to the entity incurring the expense. Where specific identification is not feasible apportionment shall be based upon pertinent factors or ratios. Any basis adopted to apportion expenses shall be that which yields the most accurate results and may result from special studies of employee activities, salary ratios, premium ratios or similar analyses. Expenses that relate solely to the operations of a reporting entity, such as personnel costs associated with the adjusting and paying of claims, must be borne solely by the reporting entity and are not to be apportioned to other entities within a group. Pertinent factors in making this determination shall include which entity has the ultimate obligation to pay the expense. Apportioned expenses are subject to presentation and allocation as provided in paragraphs 5 through 8.

10. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related exhibits to the financial statements.

11. The summary conclusions outlined above were formulated based upon, and are consistent with, current statutory accounting practices and procedures as set out in the P&C and Life/A&H Accounting Practices and Procedures Manuals, the Annual Statement Instructions and additional guidance contained in the Financial Condition Examiners Handbook. The conclusions are also consistent with the Statutory Statements of Concepts which states the following:

> SAP utilizes the framework established by GAAP.
>
> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles.

The conclusions are also consistent with the GAAP Statements of Concepts which are excerpted in paragraphs 16 and 17.

12. The exhibits to the annual statement display the effects of allocation of allocable expenses to the various categories as well as provide an appropriate level of detail as to the nature of the classifications of expenses being allocated. The disclosure required by Paragraph 10 provides disclosure as to the nature of the significant allocable expenses in those circumstances where the accompanying exhibits are not part of the company's financial statements (e.g. annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*, defines and discusses losses and loss adjustment expenses.
- Detailed classification tables, which are included in current statutory guidance for property and casualty companies, are not included in this issue paper. Such guidance is not considered necessary for the establishment of accounting standards/policies.

13. The P&C Accounting Practices and Procedures Manual, Chapter 19, Expenses, provides the following guidance:

> In the insurance industry, there are expenses involved in acquiring and underwriting policies and servicing the policyholders and third party claimants. These expenses will be discussed in this chapter. (Commissions are discussed in Chapter 18.)
>
> Regulation Number 30, called the "Uniform Classification of Expenses of Fire and Marine and Casualty and Surety Insurer," was effective January 1, 1949, for licensed New York companies. The NAIC prescribed similar uniform accounting instructions for expense reporting effective January 1, 1949. These acts brought uniformity to the industry.
>
> This uniformity is helpful since expenses are important elements of the company's operations and accurate statistics are needed for comparisons and control. The instructions for uniform classification of expenses are a part of the NAIC *Examiners Handbook—Volume I*.
>
> <u>Expense Group Classifications</u>
>
> Expenses for fire and casualty insurance companies are allocated to expense groups as follows:
>
> A. Loss Adjustment Expenses
>
> Loss adjustment expenses constitute expenses incurred in connection with the adjusting, recording, and paying of claims. (See Chapter 17-Loss and Loss Adjustment Expenses Incurred.)
>
> B. Other Underwriting Expenses
>
> Other underwriting expenses are classified into three categories as follows:

TABLE 19

General Guidelines for Classifying Expenses

Expenses to be Allocated to Expense Groups	Principal Basis for Allocation
Claim adjustment services	Direct charge to loss adjustment expense
Commission and brokerage	Direct charge to other underwriting acquisition
Advertising	Direct charge to other underwriting acquisition
Boards, bureaus, associations	Direct charge to other underwriting - general
Surveys and underwriting reports	Direct charge to other underwriting - general
Audit of insureds' records	Direct charge to other underwriting - general
Salaries	Studies of employee activities
Employee relations and welfare	Pro rate on salary ratios
Insurance	Pro rate on salary ratios
Directors' fees	Pro rate on salary ratios
Travel and travel items	Special studies
Rent and rent items	Pro rate on salary ratios
Equipment	Pro rate on salary ratios
Printing and stationery	Pro rate on salary ratios
Postage, telephone and telegraph, exchange and express	Pro rate on salary ratios
Legal and auditing	Special studies
Taxes, licenses, and fees (Except payroll taxes)	Special studies
Real estate expenses	Investment expenses
Real estate taxes	Investment expenses
Miscellaneous	Special studies

Any other basis of allocation which yields a more accurate result may be used for those expenses being allocated on the basis of salaries. Any basis of

Apportionment of Joint Expenses

Many insurance companies operate on a group basis, sharing personnel and facilities in conducting business. When this occurs, the expenses involved must be properly apportioned to the company incurring the expenses, and included in the same expense classifications as if originally paid by that company.

Some examples of specifically identifiable expenses that may be incurred solely on behalf of one company, and charged directly to the applicable company are:

1. Advertising;

2. Claims adjustment services;

3. Commissions and brokerages;

4. Taxes and real estate expenses;

5. Employees' salaries;

6. Any other expenses that can be attributed directly in whole or in part to a specific company.

The following table contains some general guidelines for apportioning joint expenses among companies.

TABLE 19-B
General Guidelines for Apportioning Joint Expenses

Expense Item	Basis for Apportionment
Advertising	Percentage of premiums
Boards, bureaus, associations	Special studies
Surveys and underwriting reports	Special studies
Audit of insureds' records	Special studies
Salaries	Studies of employee activities
Employee relations and welfare	Salaries
Insurance	Salaries
Travel and travel items	Special studies
Rent and rent items	Salaries
Equipment	Salaries
Printing and Stationery	Salaries
Postage, telephone and telegraph, exchange and express	Salaries

Legal and auditing	Special studies
Payroll taxes	Salaries
Miscellaneous	Special studies

Any other basis of allocation should be used if it yields more precise results than expenses allocated on the salaries or premium basis. If clearly inappropriate, allocation based on salaries or premium should not be employed.

A company that pays joint expenses, which are ultimately apportioned and charged to other companies in the group, should credit the apportioned expenses to the same expense items charged when the payment was made. Apportionment expenses generally should not be reported as income nor be accumulated in a separate account used to reduce total expenses for the company.

14. The Life/A&H Accounting Practices and Procedures Manual, Chapter 22, General Expenses and Taxes, Licenses and Fees, provides the following guidance:

> General expenses include virtually all of the expenses of a life insurance company other than benefits to policyholders, commissions, and taxes, licenses and fees.
>
> The statutory financial statement provides for two broad categories of general expenses: (1) insurance, which is further subdivided into life insurance, accident and health insurance, and all other lines of business and (2) investment. In addition, general expenses are allocated to more detailed lines of business in the Analysis of Operations by Lines of Business. In the Summary of Operations, the investment expense portion of general expenses is classified as an offset to investment income while general insurance expenses are reported separately in the expense section of the summary.

15. The Annual Statement Instructions for Property and Casualty Companies - Underwriting and Investment Exhibit - Part 4 - Expenses provides the following guidance:

> A company that pays any affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification items (salaries, rent, postage, etc.) as if these costs had been borne directly by the company. Management, administration, or similar fees should not be reported as a one-line expense. The company may estimate these expense allocations based on a formula or other reasonable basis.
>
> A company that pays any non-affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification item as follows:
>
> a) Payments for claims handling or adjustment services shall be allocated to “Loss Adjustment Expenses” (Column 1) in the Underwriting and Investment Exhibit–Part 4. If the total of such expenses incurred equals or exceeds 10% of the total incurred “Loss Adjustment Expenses” (Column 1, Line 22), the company shall allocate these costs to the appropriate expense classification items as if these costs had been borne directly by the company. If such expenses are less than 10% of the total, they may be reported on Line 1 of Column 1.
>
> b) Payments for services other than claims handling or adjustment services shall be allocated to the appropriate expense classification items as if these costs had been borne directly by the company, if the total of such fees paid equals or exceeds 10% of the total incurred “Other Underwriting Expenses” (Column 2, Line 22). If the total is less then 10%, the payments may be reported on Line 2 if the fees are calculated as a percentage of premium, or on Line 3 if the fees are not calculated as a percentage of premium.

> The total management and service fees paid to affiliates and non-affiliates shall be reported in the footnote to the Underwriting and Investment Exhibit-Part 4 of the annual statement, and the method(s) used for allocation shall be disclosed in the Notes to the Financial Statements. The company shall use the same allocation method(s) on a consistent basis.

The Annual Statement Instructions for Life and Accident and Health Companies contains similar guidance.

16. *FASB Statement of Financial Accounting Concepts No. 2, Summary of Principal Conclusions,* provides the following guidance:

> Comparability and Consistency
>
> Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark.

17. *FASB Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises,* provides the following guidance:

> paragraph 20
>
> Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogeneous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as continuity or recurrence, stability, risk, and reliability, are likely to have more predictive value than if their characteristics are dissimilar.

PART II
RULES RELATING TO THE ALLOCATION OF JOINT EXPENSES TO COMPANIES

1. JOINT EXPENSES

A. Joint Expenses, as described in Part 1, Sec. 22 (A), shall be allocated to companies as follows:

Expenses To Be Allocated To Companies (as amended)	Bases of Allocation to Companies
Advertising	

1. LIST OF EXPENSE GROUPS

3. ALLOCATION TO EXPENSE GROUPS (as amended)

A. Expenses shall be allocated to expense groups as follows:

Expenses To Be Allocated Expense Groups	Allocation to Expense Groups
Claim Adjustment Services:	
Direct	Loss Adjustment Expenses
Reinsurance Assumed	Loss Adjustment Expenses
Reinsurance Ceded	Loss Adjustment Expenses
Commission and Brokerage:	
Direct	See Commission and Allowances (Part III, Sec. 2 (C)(2))
Reinsurance Assumed	Acquisition, Field Supervision and Collection Expenses
Reinsurance Ceded	Acquisition, Field Supervision and Collection Expenses
Contingent—Net	Acquisition, Field Supervision and Collection Expenses
Policy and Membership Fees	Acquisition, Field Supervision and Collection Expenses
Allowances to Managers and Agents	See Commission and Allowances (Part III, Sec. 2 (C)(2))
Advertising	Acquisition, Field Supervision and Collection Expenses
Boards, Bureaus and Associations	General Expenses
Surveys and Underwriting	General Expenses
Reports	General Expenses
Audit of Assureds' Records	See Special Instructions Relating
Salaries	to the Allocation of Salaries and Other Expenses (Part V)
Employee Relations and Welfare	Overhead on Salaries
Insurance	Overhead on Salaries

Employee Relations and Welfare Employee Relations and Welfare

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 19
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 22
- Annual Statement Instructions for Property and Casualty Companies and for Life and Accident and Health Companies

- *FASB Statement of Financial Accounting Concepts No. 2, Summary of Principal Conclusions*
- *FASB Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises*

- No additional guidance obtained from state statutes or regulations.

- Financial Condition Examiners Handbook - Volume 1, Chapter 6