SOME OBSERVATIONS CONCERNING FIRE AND CASUALTY INSURANCE COMPANY FINANCIAL STATEMENTS

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DISCUSSION BY JOHN W. CARLETON

Mr. Otteson has made a valuable and provocative contribution to a subject that is of considerable current interest.

His paper has been written in a commendably clear, firm and forceful style. If any criticism attaches to the manner of presentation, it might be to the effect that he uses essentially the same style to express statements of fact, possible inferences from given facts, and statements of individual preferences. An unwary reader may occasionally find himself accepting a sentence in the last category as a sentence in the first category.

The paper covers five facets of financial statements for fire and casualty companies, relating them to the *full* and *true* wording in the jurat of the required annual statement filing. The words "full" and "true" have virtuous connotations. It is believed Mr. Otteson properly reads into them something more fundamental than filling in all appropriate blanks after mechanical compliance with instructions.

Nevertheless, I find myself resisting some of Mr. Otteson's statements and more particularly some of the premises implicit in his discussion. When people agree generally on facts and agree generally that virtue is a good thing, but disagree as to where these agreements lead, there must be a reason. In this review I want to explore briefly what seems to be the reason.

It is suspected that Mr. Otteson may feel the financial statements of fire and casualty companies should address themselves to a slightly different collection of questions than I think they should. I can build this suspicion by extrapolating from a suggestion he makes for improving what he calls the accuracy of unpaid loss liability estimates. He suggests that if more time were allowed for the runoff (or for the receipt of more information) then more accurate estimates might be made; i.e., ones closer to the values ultimately revealed by time. Some actuaries might question the contribution an extra month would make as respects some important kinds of claims. However, if one considers the schedule customarily required for the preparation and filing of the annual statement, then Mr. Otteson's suggestions fall within the range of practical possibilities. Thus, I should

acknowledge in advance some discourtesy in extrapolating out of the practical range in order to develop a possible difference between my concept of what financial statements should do and Mr. Otteson's.

When liabilities are of such a nature that they can be quantified only as more information flows in with the passage of time, it is tautological to state that a deferred filing date will usually permit a more "accurate" estimating of them. Time, in sufficient quantity, will permit a precise test of the under or oversufficiency of unpaid loss liabilities, liabilities to policyholders for insurance bought but as yet undelivered, even the policy reserves of a life company.

The ultimate in the use of time to enhance accuracy would be to look back at an insurance carrier five or ten years after it had completed its life cycle; i.e., five or ten years after it had terminated its corporate existence through sale or liquidation. From this vantage point it should be possible to put each dollar of cumulative incurred loss into its proper accounting period according to an accident date criterion, an earned premium matching criterion, or any other criterion that might be thought productive. From this vantage point it should be possible to know what ninety-day balances were collectible and what unauthorized reinsurance was in fact recoverable. From this point it should be possible to take the cost of developing a good agency plant and the cost of recruiting and training a good staff and redistribute them, generally forward, to the accounting periods that enjoyed the premium and profitability that these investments made possible—achieving a match of revenue and outgo that would exceed the demands of the most zealous professionals. We could have a very accurate recasting of balance sheets and operating statements, the word "accurate" being defined in terms of hindsight and thoroughgoing matching criteria.

Such data would have some uses but they are not the uses for which financial statements are prepared, either in the insurance business or, as far as I know, in any other business. It is thought that such a hypothetical recasting is the yardstick with which to test whether a financial statement is a full and true disclosure.

With some technical exceptions, insurance financial statements are prepared while the organization is operating as a going concern, as promptly as mechanically possible after a cutoff date, and at a point of time when the ultimate consequences of commitments made prior to that cutoff date are not only unknown but unknowable. What should be measured and disclosed to policyholders, shareholders, licensing authorities and managers when the disclosure must be made at a point of time when these direct con-

sequences of prior transactions with last year's customers cannot be quantified until further events have taken place?

It is suggested that the preferred answer to this question in terms of general usefulness, ease of communication, and comparability with other businesses is one which applies a principle that can be loosely worded something like this: The statement should be prepared in such a way that there is released into cumulative operating earnings only those portions of cumulative operating revenues which, as of the statement date, are substantially certain to still belong there after the future events have taken place. Statutory accounting is not entirely consistent with this principle, but I think it tries to be close.

AUTHOR'S REVIEW OF DISCUSSION BY MR. CARLETON

John Carleton's review evaluates the paper on an overall rather than on a point by point basis. An example or two supporting his general criticisms would make them more meaningful.

The review then proceeds to develop argument for a position or point of view concerning what the ultimate philosophy and objective of insurance company financial statements should be. This argument is summarized and crystallized into a definite "principle" in the last paragraph which reads as follows:

> "The statement should be prepared in such a way that there is released into cumulative operating earnings only those portions of cumulative operating revenues which, as of the statement date, are substantially certain to still belong there after the future events have taken place."

Concerning attitude toward financial statements, the author would agree substantially with the principle expressed; the "observations" contained in his paper are consistent with it. The last paragraph however does raise interesting questions which should at least be subject to further exploration, development, and clarification.

The principle is limited to "operating" income and revenue. Should not the same principle apply to investment valuations and increments to surplus? Present practice is much more conservative as to operating results than as to investment valuations and increments to surplus.

The full meaning of the term "release" is not quite clear. The unearned premium reserve does "release" and "withhold" prescribed proportions of the gross premium income. For other deductions the withholding and re-