Demotech, Inc.

Quality of earnings, earning management or earnings magic?

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InvestingAnswers defines "quality of earnings" as the amount of profit from core operations rather than that attributable to accounting methods, extraordinary situations or earnings management. Investopedia defines "earnings management" as the use of accounting techniques to produce financial reports that present an overly positive view of a company's business activities and financial position.

Investopedia notes that 'Many accounting rules and principles require company management to make judgments.' In the Title insurance industry, aggregate loss and loss adjustment expense (L&LAE) reserve estimates, whether at the claim file level or the incurred but not reported level, are the summation of a series of management's judgments. With the year-end statutory statement filed with the National Association of Insurance Commissioners as well as the applicable departments of insurance, an actuary opines on L&LAE reserve estimates, before and after reinsurance, that are "management's best estimate."

Insurers do not have the variety of accounting methods available to manufacturers, i.e., last in, first out (LIFO), first in, first out (FIFO), highest in, first out (HIFO), or weighted average cost method (WAC). Given this situation, how might an insurer 'use accounting techniques to produce financial reports that present an overly positive view of a company's business activities and financial position?' The answer is that company management can select an overly positive estimate of the ultimate cost of L&LAE reserves from the range of reasonable loss and LAE reserve estimates produced by a variety of generally accepted actuarial procedures. Using an overly positive view of ultimate loss and LAE reserves results in an optimistic estimate of statutory pretax earnings.

Should insurer management select an overly positive view of its loss and LAE reserves, and thereby overstate pretax earnings as well as its financial position, how would anyone outside the carrier learn of this? Equally as important, if carriers have consistently selected overly positive estimates of their L&LAE reserves, thereby reporting overly positive earnings and yet were assigned lofty ratings by the legacy rating agencies, how would anyone uncover the true situation?

The response to this question is answered by each year's statutory financial statement, as it requires management to revisit its prior period estimate of loss and LAE reserves and re-evaluate the integrity of that earlier estimate. This provides the information necessary to assess the quality of earnings of the prior year. Insurers calculate and report whether their prior period statutory pretax earnings were optimistic or realistic.

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In the statutory annual statement, Five-Year Historical Data, page 17, the company discloses the result of its comparison of initial estimate of L&LAE reserves to a more current view of its earlier estimate. There are two such re-evaluations. The first is the adjustment measured one year after the initial estimate of reported earnings. The second is two years after the initial estimate. These are lines 66 and 70 of the Five-Year Historical Data. We believe that the one-year development is a more pertinent measurement of adjusted earnings, as earnings decisions are typically made annually, i.e., management selects initial L&LAE reserves as part of the year-end financial planning. This is where an overly optimistic estimate of L&LAE reserves is most likely to occur. The market capitalization, share price, and brand of publicly traded entities depends on operating results. If the publicly traded company is part of the insurance industry, the statutory pretax earnings generated by insurer subsidiaries are the driving force behind the competition for capital and the satisfaction of the demands imposed by investors. Publicly traded entities utilizing a realistic, as opposed to an overly positive view, of L&LAE reserves should be rewarded for doing so. That is, ceteris paribus, they deserve higher market capitalization and price to earnings ratios than entities reporting comparable levels of statutory pretax earnings that do not withstand management's self-imposed test of time.

Although the translation of pretax statutory earnings to pretax earnings under generally accepted accounting principles (GAAP) is beyond the scope of this discussion, rest assured that there is a direct correlation between overly positive pretax statutory insurance accounting earnings and overly positive pretax GAAP earnings. As such, Demotech introduces SPEQUELLAE, the first widely distributed metric to quantify, based upon self-reported information, the quality of the pretax statutory earnings reported by carrier management. SPEQUELLAE will be updated on an annual basis as earlier L&LAE estimates are re-evaluated by management.

SPEQUELLAE is Demotech's acronym for:

Statutory
Pretax
Earnings
Quality
Using
Emerging
Loss and
Loss Adjustment Expense
Estimates.

SPEQUELLAE measures the impact of the adverse or favorable loss and LAE development, as reported by management, on initial reports of statutory pretax earnings. A SPEQUELLAE index of 100 or higher indicates that management has historically been obsessed on the integrity of its reported pretax statutory earnings. This situation exists because future loss and LAE development affirms the integrity of management's initial report of its statutory pretax income.

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The calculation of an annual SPEQUELLAE index for an under reserved company is:

$$100 * \left(1 - \frac{|\text{L\&LAE Reserve Development Reported One-Year Later}|}{|\text{Statutory Pretax Earnings Year X}|}\right)$$

The calculation of an annual SPEQUELLAE index for an over reserved company is:

$$100 * \left(1 + \frac{|\text{L\&LAE Reserve Development Reported One-Year Later}|}{|\text{Statutory Pretax Earnings Year X}|}\right)$$

|| denotes absolute values

By subtracting the ratio of L&LAE reserve development when loss and LAE reserve development is unfavorable, SPEQUELLAE represents the reduction to the earlier reported statutory pretax income. Conversely, by adding the ratio of L&LAE reserve development when loss and LAE reserve development is favorable, SPEQUELLAE represents the increase to the earlier reported statutory pretax income. The integrity of the initial reported statutory pretax income was affirmed by the emerging loss and LAE reserve estimates associated with the calendar year's reported earnings. A SPEQUELLAE index below 100 indicates the degree to which initial statutory pretax earnings have tended to be overstated.

We calculated SPEQUELLAE on a cumulative five-year basis as well as year-by-year over the period 2011 through 2015, with an adjustment for the one-year loss and LAE reserve development reported at December 31, 2016. We offer the following observations based upon what we believe to be the first industrywide analysis of the quality of statutory pre-tax income. We answer the question - how much of the reported statutory pre-tax earnings was realizable, given future loss and LAE reserve development?

In our opinion, a SPEQUELLAE index of 100+ indicates that over the period subjected to review, management was **obsessed** with the selection of a realistic estimate of L&LAE reserves and therefore the quality of reported pretax statutory earnings have held up. The earnings reported in the prior periods have withstood management's re-evaluation of the initial L&LAE reserve estimate utilized by management. The integrity of pretax statutory earnings and the related balance sheet liability for loss and LAE reserves was likely to be the result of management's obsession on realizable earnings as well as a commitment to balance sheet integrity.

In our opinion, a SPEQUELLAE index of 95 up to 100 indicates that over the period subjected to review, management was **fixated** on the selection of a realistic estimate of L&LAE reserves that would hold up over time. Reported pretax statutory earnings all but withstood management's re-evaluation of its earlier L&LAE reserve estimate. The integrity of pretax statutory earnings and the related balance sheet liability for L&LAE reserves is likely to be the result of a fixation on earnings and balance sheet integrity.

In our opinion, a SPEQUELLAE index of 90 up to 95 indicates that over the period subjected to review, management was **focused** on the selection of a realistic estimate of L&LAE reserves and statutory pretax income. However, the realization of the previously reported statutory pretax earnings have eroded due to management's need to increase its prior period loss and LAE reserve estimates to a more realistic level.

In our opinion, a SPEQUELLAE index of 85 up to 89 indicates that over the period subjected to review, management was **attentive** to the selection of L&LAE reserves but was overly optimistic. The earlier L&LAE estimates underlying reported statutory pretax income have not held up well.

In our opinion, a SPEQUELLAE index below 85 indicates that over the period subjected to review, the statutory pretax earnings reported by management were **optimistic.** Earnings were unlikely to be representative of the carrier's core operations because future adverse L&LAE reserve development eroded the quality of management's previously reported statutory pretax earnings.

These calculations of the SPEQUELLAE index are based upon the statutory pretax earnings reported over calendar years 2011 through 2015 adjusted by the published loss and LAE reserve development at year-end 2012 through 2016. SPEQUELLAE indices for 2012 through 2016 adjusted by the published loss and LAE reserve development at year-end 2017 are expected to be published in May 2018.

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