Accounting Conservatism in the Property-Liability Insurance Industry

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Abstract

In this paper, we study two types of accounting conservatism in the property-liability (P&L) insurance industry – ex-ante and ex-post conservatism. Ex-ante conservatism means that firms over-report liabilities initially, before more detailed information becomes available. In contrast, ex-post conservatism means that firms respond to this new information asymmetrically by recognizing expected losses more quickly than expected gains. We explore three research questions: (1) whether ex-ante and ex-post conservatism exists in the P&L insurance industry; (2) what the relations are between ex-post conservatism and other managerial incentives, including ex-ante conservatism, income smoothing, inflating financial strength ratio, taxation, and rate regulation; and (3) how much the opportunity cost is for being conservative in reserving. Our analysis focuses on loss reserve accruals since it is the most significant accruals on the balance sheet. One benefit of studying the P&L insurance industry is that we have specific and detailed information regarding the development of loss reserve accruals over time. Ex-ante conservatism is simply a positive bias in the initially reported incurred losses. The measure of ex-post conservatism is a regression coefficient that reflects the asymmetric timeliness of incurred losses in reporting good and bad news. We study all U.S. domiciled P&L insurance companies from 1996 to 2012. Our results show that P&L insurers, on average, significantly engage in both ex-ante and ex-post conservatism. The usage of ex-ante conservatism preempts the adoption of ex-post conservatism, but the relationship is nonlinear and a U-shape. This finding indicates that firms use ex-ante and ex-post conservatism to achieve different goals so that ex-ante conservatism cannot eliminate the space for ex-post conservatism. Moreover, we find that the level of ex-post conservatism is also restricted by income smoothing incentive, the incentive to inflate financial strength ratio, and high premium exposures to strict rate regulation. Finally, we test whether insurers are overly ex-post conservative and reserve more losses than needed. We do not find evidence supporting this prediction. Our back-of-the-envelope estimates indicate that the opportunity cost of engaging in accounting conservatism is modest.

Keywords: Ex-ante conservatism, Ex-post conservatism, Loss reserves, Nonlinear relationship, Opportunity cost

JEL Classification: G22, G28, G33, M41, M48

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