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Accounting for Medical Malpractice Claims Obligations by Health Care Entities

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Managing risk of loss related to medical malpractice claims is a significant operational and financial consideration for many health care entities. It also presents several financial reporting and accounting challenges for organizations due to both the complexity of the risk management structures used as well as the complexity of promulgated accounting standards.

Although health care entities manage their risk through a variety of structures including higher deductible plans, self-insured retentions, retrospective premiums, and captive insurance companies, health care entities typically use commercial insurance to manage some portion of the risk of loss from medical malpractice. It's critical that each health care entity identify its risk and the portion of that risk that is covered by insurance, since an assessment of the insured risk is necessary for the determination of anticipated insurance recoveries, a fundamental concept in measuring the financial statement impact of medical malpractice claim obligations.

Policy Coverage Types

Insurance policies may be issued on an occurrence basis, a claims-made basis, or a claims-made-and-paid basis. Occurrence basis policies provide coverage for insured events occurring during the policy period, regardless of when the claims are made. A claims-made policy provides coverage that is triggered when a claim is made during the coverage period for insured events occurring on or after the retroactive effective date of the policy. As a result, a claims-made policy does not cover claims for insured events occurring during the policy period but not reported until after the expiration of the policy. Claims-made-and-paid policies are relatively new and provide different coverage features and costs than policy types with which you may be more familiar. A claims-made-and-paid policy covers claims—for insured events occurring on or after the retroactive date of the policy—that are reported, settled, and paid during the current or subsequent policy period.

These different policy structures often have different premium pricing structures because of the amount of risk undertaken by the insurer. An occurrence-basis policy generally has higher premiums but offers more incident coverage (subject to policy limits) during the policy period while a claims-made-and-paid policy generally has lower premiums and less incident coverage. Consequently, health care entities may make policy structure decisions based on strategic risk management, economic, and cash flow factors that have significantly different financial reporting implications.

Financial Accounting and Reporting for FASB Reporters

While accounting for contingencies, codified in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 450, is the underlying basis of accounting for medical malpractice, FASB ASC Topic 954-450 contains very specific guidance regarding accounting for medical malpractice claim contingencies for health care entities. In this guidance, there are two critical concepts:

- That claims obligations should not be presented net of any anticipated insurance recovery nor should anticipated recoveries be included in the estimation of claims obligations.

- That recorded liabilities for claims obligations should account for the ultimate estimated cost of the claims at the time of the incident that gives rise to the claims, including costs to litigate and settle the claim and an estimate of costs related to claims incurred but not reported

The first concept is the most critical aspect of financial reporting for claims obligations. Because claims obligations are accounted for at the date the incident occurs and determined and recorded without consideration of the risk management strategy, the recorded liability for medical malpractice claims obligations would be the same amount regardless of whether the health care entity was insured, what type of insurance the health care entity carries, and the period of coverage. The differences in financial reporting resulting from the different types of insurance policies relate almost exclusively to the insurance recovery receivable that is separately recorded based on the nature of the entity's risk management strategy.

Recoveries Receivable

According to FASB ASC 954-450-25-2, to the extent that an entity is indemnified for claims obligations, the entity should recognize an insurance recovery receivable at the same time that it recognizes the liability. An asset relating to the recovery may be recognized only when realization of the claim for recovery is deemed probable, and it is subject to the need for a valuation allowance for uncollectible amounts.

Thus, under an occurrence-basis policy in force through the end of the period, the claims recovery receivable prior to valuation would be expected to equal the liability because the entity is indemnified for all claims incurred during the period, regardless of when they are reported. However, under a claims-made policy, a receivable for only the claims reported through the end of the period would be recognized, and a receivable would not be recorded for claims incurred but not reported. For a claims-made-and-paid policy, no recovery receivable would be recognized, since accrued claims are not covered under the policy until they are paid. Again, the recorded liability will not vary based on the type of policy in place, but the recovery receivable could vary significantly depending on the risk management strategy.

Claims Obligation Liabilities

Estimating medical malpractice claims obligations can involve complex claim reserve and lag models and often requires actuarial assistance. For the best estimates of the ultimate costs of malpractice claims, health care entities should take into consideration how malpractice claims develop over time and include an estimate of the losses that will result from unreported incidents which are probable of having occurred before the end of the reporting period. FASB ASC 944-40 discusses accounting for claims costs, including estimates of costs relating to incurred-but-not-reported claims. The AICPA's Audit and Accounting Guide for Health Care Entities suggests that insurance entity guidance at FASB ASC 944-40 may be analogous and helpful in estimating loss liabilities.

FASB ASC 954-450-25-2A indicates that accruals should not be based on recommended funding amounts, which may be a common component of actuarial analysis and is certainly a component of management's risk management selection strategy. As discussed, certain risk management strategies may provide a cash flow advantage for an organization but result in different accounting treatment than other strategies.

Presentation

Consistent with industry practice and US generally accepted accounting principles, components of the claims obligations that are not expected to be settled in the next year should be reported as long-term liabilities. Current and long-term classification of any recoveries receivable should also be considered.

Disclosure

Although recovery receivable accounting varies depending on the risk management strategy, disclosure requirements do not. A health care entity is required to disclose its program of medical malpractice insurance coverage, typically including the nature of the coverage, related terms, expected recoveries, and the basis for any loss accruals. Significant changes in estimates related to recoveries receivable and claims obligations should also be disclosed.

Frequently Asked Questions

Does the renewal of insurance policies subsequent to year-end but before the issuance of financial statements impact the accounting at year-end?

No. The liability is determined irrespective of the insurance policy. For insurance recoveries, an entity could consider insurance coverage that was in place at the end of the reporting period, even if the expiration extended past the end of the year. However, subsequent renewals would not be considered in estimating an insurance recovery, since those would be Type II subsequent events (FASB ASC 855-10-25).

Would stop-loss coverage be considered as part of insurance recovery receivable estimation?

Yes. Risk management strategies, including stop-loss coverage, that indemnify an entity from claims should be considered for insurance claims coverage receivables.

We're Here to Help

Keep in mind that the accounting and reporting considerations we've addressed here relate to medical malpractice claims obligations for FASB reporters. Governmental Accounting Standards Board (GASB) reporters should apply the insurance-related contingency guidance located primarily in GASB Statement No. 10. Many of the concepts described above apply to GASB reporters; however, GASB Statement No. 10 discusses whether risk has, in fact, been transferred when determining whether to recognize a loss, and it states that claims obligations are to be reduced by amounts expected to be recovered by insurance.

Accounting for and reporting on medical malpractice claims is a complicated matter that can have a significant impact on a health care organization's financial statements. The AICPA's Audit and Accounting Guide for Health Care Entities and FASB ASC 954-450 are great resources for additional guidance.

If you have any questions about accounting for medical malpractice claims, contact your Moss Adams health care professional.

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