Statutory Issue Paper No. 3

Accounting Changes

STATUS
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Original SSAP and Current Authoritative Guidance: SSAP No. 3

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Statutory accounting and GAAP differ in accounting for corrections of errors and certain changes in accounting. Statutory accounting and GAAP are similar in their treatment of mergers and changes in reporting entities. The purpose of this issue paper is to codify statutory guidance and to expand disclosure requirements for changes in accounting, which include changes in accounting principle, estimate, and reporting entity, and for correction of an error in previously issued financial statements in order to achieve the concept of consistency/comparability as defined in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. The term accounting change means a change in an accounting principle, an accounting estimate or the reporting entity. The correction of an error in previously issued financial statements is not deemed to be an accounting change.

Accounting Principle
3. A change in accounting principle results from the adoption of an accepted accounting principle different from the one previously used for reporting purposes. An accounting principle includes not only accounting principles and practices but also the methods of applying them.

4. A characteristic of a change in accounting principle is that it concerns a choice from among two or more accounting principles. However, neither (a) initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring is a change in accounting principle.

Accounting Estimate
5. Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements which require estimating the effects of future events. Examples of items for which estimates are necessary include service lives of depreciable assets and uncollectible receivables. Accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.

Correction of an Error
6. Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgment. Thus an error is distinguished from a change in estimate.

7. Current statutory treatment shall be retained as follows:

- Changes in accounting principles and corrections of errors in previously reported financial statements shall be reported as adjustments to surplus in the period of the change in accounting principle or the period an error is detected.
- A change in the method of applying an accounting principle shall be considered as a change in accounting principle for purposes of applying the accounting principles set forth in this paper.
- A change in accounting estimate shall be included in the statement of income in the period when the change becomes known.

8. If the effect of a change in accounting principle is inseparable from the effect of a change in accounting estimate, then the change shall be considered as a change in accounting estimate for purposes of applying the accounting principles set forth in this paper. The treatment of a change resulting from an insurance department examination will depend on whether the change resulted from a correction of an error, a change in accounting principle or a change in estimate.

9. Material changes which do not affect assets, liabilities, revenues, expenses or surplus but which do affect historical information in the financial statement supplemental schedules (e.g., Schedule P) shall be reflected in the current years' schedules with appropriate notations made directly to the affected schedules and in the notes to the financial statement.

10. For mergers, restatement of prior years' amounts in the Annual Statement shall be required. Additionally, restatement shall be required for the two most recent years' included in the Five Year Historical Summary. The Five Year Historical Summary shall include a footnote that the other three years have not been restated. A company that merges with an entity which effectively is a shell company (i.e., the other entity has no outstanding underwriting liabilities), shall be exempt from the above requirements.

Disclosures

11. Disclosure of material changes in accounting and correction of errors shall include:

- a brief description of the change, encompassing a general disclosure of the reason and justification for change or correction.
- the impact of the change or correction on net income, surplus, total assets and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations).
- the effect on net income of the current period shall be disclosed for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material.

DISCUSSION

12. *Accounting Principles Board Opinion No. 9*, *Reporting the Results of Operations* (APB 9) and *Accounting Principles Board Opinion No. 20*, *Accounting Changes* (APB 20) address GAAP accounting and reporting for accounting changes. Portions of these pronouncements are not applicable to statutory accounting and some of the guidance is not consistent with statutory objectives. Therefore, rejection of APB 20 in its entirety and the portions of APB 9 that address the treatment of extraordinary items and prior period adjustments is recommended.

13. The consistency concept within the Statement of Concepts is concerned with the regulator's need for meaningful, comparable financial information to determine an entity's financial condition through

consistency in the development and application of statutory accounting principles. In keeping with the Statement of Concepts, comparability of financial information would be best served by the restatement of prior year financial information for certain changes in accounting principle as well as the correction of an error in the previous year. However, existing statutory accounting guidance and practice requires such an item to be shown as an adjustment to surplus. In order to bridge the gap between current statutory accounting guidance and the achievement of comparability sought by the Statement of Concepts, additional disclosure as to the general description and the effect of such changes on income and surplus for all periods presented would provide the financial statement reader enough information to understand the effect of such change on consistency between periods.

14. The modification of existing statutory accounting for additional disclosure relating to changes between years and correction of prior errors bridges the gap between GAAP accounting as required by APB 20 and APB 9. More importantly, the added disclosure bridges the gap between current statutory procedures and the concept of consistency/ comparability required by the Statement of Concepts.

Drafting Notes/Comments

- Accounting for Consolidations of Majority-owned Subsidiaries is addressed in a separate issue paper (see Issue Paper No. 1).
- Accounting for mergers is addressed in a separate issue paper. This may include an expansion of the traditional definition of a merger to include all combinations or assumptions which, in substance, are mergers.
- Extraordinary items are discussed in a separate issue paper.
- Specific discussion regarding reserve changes including a change in valuation basis is addressed in a separate paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

15. Statutory accounting is specific as to the treatment of accounting changes. The primary statutory accounting guidance is the NAIC Annual Statement Instructions (Annual Statement Instructions). Summarized, the Annual Statement Instructions specify that a change in accounting principle or the correction of an error is to be reported as an adjustment to surplus. Changes in accounting estimates are to be included in the statement of income for the current period. The treatment for a merger requires that prior year's amounts be restated and reported on a merged basis consistent with the current year's post-merger reporting basis.

16. The issues of changes in accounting principles and estimates are not specifically addressed in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies.

17. Chapter 10 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, in a discussion on recoveries from salvage and subrogation, states that:

> Companies which have previously reported reserves gross of salvage and subrogation should report the change to the net method as a change in accounting principle. The cumulative effect on prior years of this change should be reported as a write-in item in the surplus section of the annual statement. The change in the reserve calculated using the net method should be included in net income for the year of the change and all future years.

18. The Annual Statement Instructions (which documents the conclusions reached by the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force in meeting 92-1) addresses accounting changes. The instructions state that:

Amounts reported in prior years may need to be adjusted in the current year as a result of the following:

Changes in accounting principles or practices or changes in the methods of applying accounting principles or practices.

Changes in accounting estimates as a result of new events or new information.

Corrections of errors in previously filed information.

A merger.

If changes are required for amounts reported in prior years, such changes should be included in the amounts reported for the current year and the effects of such changes should be reported as follows, unless these Instructions or the NAIC Accounting Practices and Procedures manual specifically provide for a different treatment:

(1) The cumulative effect of a change in accounting principles or practices or a change in the method of applying accounting principles or practices should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus. The cumulative effect of changing to a new accounting principle is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods. An example of a change in accounting principles would be a change in the method of accounting for pensions or other post-employment benefits.

(2) The effects of changes in accounting estimates are included in income and expenses in the Statement of Income for the current year. For example, a change in the estimate of loss reserves for losses related to prior years should be included in the Statement of Income in losses incurred for the current year.

(3) The effects of changes resulting from corrections of errors in previously filed information (for example, mathematical mistakes, misapplication of accounting principles, or oversight or misuse of facts) should be reported as an adjustment to surplus in the current year. Such adjustments to surplus should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus.

(4) In the case of a merger, prior years' amounts reported for assets, liabilities, surplus, revenues and expenses, as well as those amounts reflected in supporting Annual Statement schedules, should be reported on a merged basis consistent with the current year's post-merger reporting basis. A footnote should be inserted on each page of the Annual Statement which contains such merged amounts clearly detailing the circumstances.

If one of the above described adjustments is required that does not affect assets, liabilities, revenues or expenses but which does adjust historical information, such as that found in Schedule P, the change may be made in the currently filed annual statements; however, appropriate notations of such adjustments should be made directly on the schedules affected and in the notes to the Financial Statements.

Generally Accepted Accounting Principles

19. Statutory accounting treatment is similar to GAAP except for the following:

- when reporting changes in accounting principles, GAAP accounting requires that the cumulative effect of a change be reported in the statement of income as a separate line item. Statutory accounting requires this to be shown as a separate component of surplus.
- GAAP accounting requires that corrections of errors be reported as prior period adjustments with adjustment to the prior year income and surplus.
- accounting for changes in a reporting entity includes several circumstances in which there may be a change in reporting entity. The only relevant area as it applies to Statutory Accounting is that of a merger. As such, this is the only area which Statutory Accounting specifically addresses.

20. The primary GAAP accounting guidance with respect to accounting changes comes from APB 20, paragraph 19, which states that changes in accounting principles are to be reported as follows:

a. Financial statements for prior periods included for comparative purposes should be presented as previously reported.

b. The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of the period of the change.

c. The effect of adopting the new accounting principle on income before extraordinary items and on net income of the period of the change should be disclosed.

d. Income before extraordinary items and net income computed on a pro forma basis should be shown on the face of the income statements for all periods presented as if the newly adopted accounting principle had been applied during all periods affected.

21. APB 20 also states that changes in accounting estimates are to be accounted for as follows:

...the effect of a change in accounting estimate should be accounted for in
a. the period of change if the change affects that period only or
b. the period of change and future periods if the change affects both.

A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

22. For changes in the reporting entity (e.g., a merger), APB 20 states the following:

...accounting changes which result in financial statements that are in effect the statements of a different reporting entity should be reported by restating the financial statements of all prior periods presented in order to show financial information for the new reporting entity for all periods.

23. For changes in accounting principles inseparable from changes in accounting estimates, APB 20 states:

Changes of this type are often related to the continuing process of obtaining additional information and revising estimates and are therefore considered as changes in estimates for purposes of applying this Opinion.

24. Lastly, according to APB 20, corrections of errors are to be accounted for as follows:

Correction of an error in the financial statements of a prior period discovered subsequent to their issuance should be reported as a prior period adjustment.

25. GAAP accounting provides guidance with respect to the accounting for prior period adjustments in APB 9, paragraph 18. APB 9 states that *"When comparative statements are presented corresponding adjustments should be made of the amounts of net income (and the components thereof) and retained earnings balances (as well as of other affected balances) for all of the periods reported therein, to reflect the retroactive application of the prior period adjustments."* Additionally, APB 9 requires footnote disclosures regarding such changes.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 10, *Losses*
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force Minutes, 92-1, 91-4
- NAIC Annual Statement Instructions

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 9, Reporting the Results of Operations*
- *Accounting Principles Board Opinion No. 20, Accounting Changes*
- *FASB Statement No. 16, Prior Period Adjustments*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Draft discussion materials from previous Property/Casualty codification projects, *Prior Period Adjustments/Corrections of Errors*

