

Statutory Issue Paper No. 77

Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures

STATUS

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Original SSAP and Current Authoritative Guidance: SSAP No. 1

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. GAAP guidance for the disclosure of accounting policies is contained in *Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies* (APB 22). This guidance requires the identification and description of accounting principles followed by a company and the methods of applying those principles that materially affect the determination of financial position or results of operations. Current statutory guidance requires a general disclosure that the financial statements have been prepared in accordance with the Annual Statement Instructions and Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals) except to the extent state laws differ. The impact of such deviations is required to be disclosed if material. The disclosure of certain accounting policies within specific notes to the Annual Statement is required by the Annual Statement Instructions.
2. GAAP guidance for the disclosure of permitted accounting practices is contained in *AICPA Statement of Position No. 94-5, Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises* (SOP 94-5). This guidance requires the disclosure of those permitted statutory accounting practices that have a material impact on statutory surplus or risk based capital or when prescribed statutory accounting practices do not address the accounting for the transaction. Current statutory guidance is contained in the Annual Statement Instructions for both Property and Casualty and Life, Accident and Health Insurance Companies (Annual Statement Instructions), *Notes to the Financial Statements*. This guidance requires the disclosure of any accounting practices not in conformity with the Annual Statement Instructions and the Accounting Practices and Procedures Manuals.
3. GAAP guidance for the disclosure of risk and uncertainties is contained in *AICPA Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties* (SOP 94-6). This guidance requires the disclosure about risks and uncertainties in four areas at the date of the financial statements: nature of operations, use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations. Current statutory guidance requires certain specific disclosures of risks and uncertainties, however, the requirements are not as broad as those of SOP 94-6.
4. The purpose of this issue paper is to establish statutory accounting principles for the disclosure of accounting policies, risks and uncertainties, and other disclosures that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

5. Except as noted in paragraph 8, the disclosure requirements of paragraphs 6-21 of this issue paper do not apply to quarterly financial statements. To the extent that disclosures required by this or any other

issue paper are made within specific notes, schedules or exhibits to the financial statements, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements which are not accompanied by Annual Statement exhibits and schedules (e.g., annual audit report) shall include all disclosures required by this statement.

Accounting Policies

6. For the purposes of this issue paper, accounting polices are defined as the specific accounting principles and the methods of applying those principles that are utilized in preparing the statutory financial statements.

7. Disclosure shall be made of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations of the reporting company. The disclosure should encompass important judgments as to the appropriateness of principles relating to recognition of revenue particularly when selecting between acceptable alternatives, or methods particular to the business.

8. Disclosure of accounting policies generally should be made in a separate *Summary of Significant Accounting Policies* preceding the notes to the financial statements or as the initial note. If the reporting entity has changed the accounting policies since the end of its preceding year, the changes shall be disclosed in the quarterly financial statements.

9. NAIC statutory accounting practices and procedures are those that are set forth in the Accounting Practices and Procedures Manual. If a reporting entity employs accounting practices that depart from NAIC accounting practices and procedures, disclosure of the following information about those accounting practices that affect statutory surplus or risk-based capital shall be made:

- a. A description of the accounting practice.
- b. A statement that the accounting practice differs from NAIC statutory accounting practices and procedures.
- c. The monetary effect on statutory surplus of using an accounting practice which differs from NAIC statutory accounting practices and procedures.

10. Disclosure of the following information shall be made about accounting practices when NAIC statutory accounting practices and procedures do not address the accounting for the transaction:

- a. A description of the transaction and of the accounting practice used.
- b. A statement that NAIC statutory accounting practices and procedures do not address the accounting for the transaction.

Risks and Uncertainties

11. Companies shall make disclosures in their financial statements about risks and uncertainties existing as of the date of those statements in the following areas:

- a. Nature of operations
- b. Use of estimates in the preparation of financial statements
- c. Certain significant estimates
- d. Current vulnerability due to certain concentrations

12. *Nature of Operations*: Financial statements should include a description of the ownership and relationships of the reporting entity and all affiliated companies, and a description of the major products

or services the reporting entity sells or provides and its principal markets, including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination (e.g., assets, revenues, or earnings). Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as predominately, about equally, or major.

13. *Use of Estimates in the Preparation of Financial Statements:* Financial statements shall include an explanation that the preparation of financial statements in conformity with the Annual Statement Instructions and Accounting Practices and Procedures Manuals requires the use of management's estimates.

14. *Certain Significant Estimates:* Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

- a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- b. The effect of the change would be material to the financial statements.

The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term (generally, a period of time not to exceed one year from the date of the financial statements). If the estimate involves a loss contingency as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies, and Impairments of Assets* (Issue Paper No. 5), the disclosure shall include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Reporting entities should disclose the factors that cause the estimate to be sensitive to change.

15. *Current Vulnerability Due to Certain Concentrations:* Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks manifest themselves differently, depending on the nature of the concentration, and vary in significance.

16. Financial statements shall disclose the concentrations described in paragraph 17 of this issue paper if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

- a. The concentration exists at the date of the financial statements.
- b. The concentration makes the enterprise vulnerable to the risk of a near-term severe (more than material but less than catastrophic) impact.
- c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

17. Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph 16 of this issue paper. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

- a. *Concentrations in the volume of business transacted with a particular customer, supplier, or lender.* The potential for the severe impact can result, for example, from total or partial

- loss of the business relationship. For the purposes of this issue paper, it is always considered at least reasonably possible that any customer will be lost in the near term.
- b. *Concentrations in revenue from particular products or services.* The potential for severe impact can result, for example, from volume or price changes for a particular source of revenue.
 - c. Concentrations in the available sources of materials, labor, services, licenses, or other rights used in the entity's operations. The potential for severe impact can result, for example, from changes in the availability to the entity of a resource or a right.
 - d. *Concentrations in the market or geographic area in which an entity conducts its operations.* The potential for severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For the purposes of this issue paper, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

Other Disclosures

18. Separate issue papers have disclosure requirements specific to the topics addressed in those issue papers. Additional disclosure requirements not addressed in other issue papers are included herein.

19. For each year that a balance sheet is presented, reporting entities shall disclose the following information in the notes to the financial statements:

- a. Amounts not recorded in the financial statements that represent segregated funds held for others, the nature of the assets and the related fiduciary responsibilities associated with such assets. One example of such an item is escrow accounts held by title insurance companies.
- b. The amount and nature of any assets pledged to others as collateral.

20. The financial statements shall disclose forward commitments which are not derivative instruments (e.g., the commitment to purchase a GNMA security two months after the commitment date, or a private placement six months after the commitment date).

Supplemental Investment Disclosure

21. For the current year, reporting entities shall disclose the information required by Appendix A-001, Investments of Insurers. A Summary Investment Schedule and Investment Risk Interrogatories shall be filed with the audited statutory financial statements. The Summary Investment Schedule shall be filed with the Annual Statement whereas the interrogatories shall be filed as a supplement to the Annual Statement by April 1 for the applicable reporting period.

DISCUSSION

22. This issue paper adopts APB 22, Accounting Research Bulletin No. 43, Chapter 2A, *Form of Statements – Comparative Financial Statements*, SOP 94-5 and SOP 94-6. The disclosures related to loss reserves adopted in *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55), are consistent with the guidance in SOP 94-5. However, Issue Paper No. 55 did not adopt SOP 94-5 because it was to be addressed in its entirety in this issue paper.

23. The statutory principles outlined in the conclusion above expand current statutory guidance relative to accounting policies, risks and uncertainties and other disclosures as follows:

- a. Paragraph 7 of this issue paper requires disclosure of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations in all statutory financial statements. Current statutory guidance requires disclosure of certain accounting policies in the notes to the Annual Statement as well as disclosure of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations but only to the extent those financial statements are audited.
- b. Paragraph 11 requires the disclosure of certain risks and uncertainties existing at the date of the financial statements. Current statutory guidance requires this disclosure in statutory financial statements to the extent those financial statements are audited. This issue paper expands that requirement to include annual statement filings.

These changes were made to enhance the usefulness of financial statements to regulators and other users.

24. The statutory principles outlined in paragraphs 9 and 10 in the conclusion above expand current statutory guidance by requiring disclosure of accounting practices that depart from NAIC accounting practices and procedures and that have an effect on risk based capital or statutory surplus. This change was made because risk based capital is viewed as a primary indicator of a reporting entity's solvency.

25. The disclosure requirements of this issue paper are consistent with the Statement of Concepts which states "... *management must supplement the financial statements with sufficient disclosures (e.g., notes to financial statements, management discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.*"

26. The conclusions reached in this issue paper are consistent with GAAP except to the extent they are not required to be made in interim statutory financial statements. GAAP requires these disclosures in all financial statements regardless of the period.

27. The information required by this issue paper provides disclosure in those circumstances where the accompanying exhibits and schedules are not part of the company's financial statements (e.g., annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

Drafting Notes/Comments

- The disclosure requirements of this issue paper relative to risks and uncertainties are separate from and do not change in any way the requirements or criteria of Issue Paper No. 5.
- Disclosures relating to environmental liabilities are addressed in *Issue Paper No. 65—Property Casualty Contracts*.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

28. The Annual Statement Instructions for both Property and Casualty and Life, Accident and Health Insurance Companies (Notes to the Financial Statements) provide the following guidance:

1. **Basis of Presentation**

Instruction:

Indicate that the statement has been completed in accordance with the NAIC *Annual Statement Instructions* and *Accounting Practices and Procedures* manuals except to the extent that state law differs. Note any deviations from the rules to the extent this deviation impacts the financial information contained in the annual statement.

Illustration:

The accompanying financial statements of the Company have been prepared in conformity with the *Annual Statement Instructions* and *Accounting Practices and Procedures* Annual Statement Instructions except for the following item(s) which resulted in surplus being increased (decreased) by \$_____. The deviation(s) are as follows:

Generally Accepted Accounting Principles

29. APB 22 provides the following guidance (note all references to statement of changes in financial position have been amended to statement of cash flows by FASB Statement No. 95, *Statement of Cash Flows*):

DISCUSSION

5. Financial statements are the end product of the financial accounting process, which is governed by generally accepted accounting principles on three levels: pervasive principles, broad operating principles, and detailed principles.¹ Applying generally accepted accounting principles requires that judgment be exercised as to the relative appropriateness of acceptable alternative principles and methods of application in specific circumstances of diverse and complex economic activities. Although the combined efforts of professional accounting bodies, of business, and of the regulatory agencies have significantly reduced the number of acceptable alternatives and are expected to reduce the number further, judgment must nevertheless be exercised in applying principles at all three levels.

¹ See *APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, Chapter 6, 7, and 8. This Opinion amends Statement No. 4 insofar as it relates to disclosure of accounting policies.

6. The accounting policies of a reporting entity are the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles and that, accordingly, have been adopted for preparing the financial statements.

7. The accounting policies adopted by a reporting entity can affect significantly the presentation of its financial position, cash flows, and results of operations. Accordingly, the usefulness of financial statements for purposes of making economic decisions about the reporting entity depends significantly upon the user's understanding of the accounting policies followed by the entity.

OPINION

Applicability

8. The Board concludes that information about the accounting policies adopted by a reporting entity is essential for financial statement users. When financial statements are issued purporting to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles, a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements. In circumstances where it may be appropriate to issue one or more of the basic financial statements without the others, purporting to present fairly the information given in accordance with generally accepted accounting principles, statements so presented should also include disclosure of the pertinent accounting policies.

9. The Board also concludes that information about the accounting policies adopted and followed by not-for-profit entities should be presented as an integral part of their financial statements.

10. The provisions of paragraphs 8 and 9 above are not intended to apply to unaudited financial statements issued as of a date between annual reporting dates (e.g., each quarter) if the reporting entity has not changed its accounting policies since the end of its preceding fiscal year.²

² The Board recognizes also that it may be appropriate to omit disclosure in some other circumstances for example, from financial statements restricted to internal use only (see Statement on Auditing Procedures No. 38, paragraphs 5 and 6) and from certain special reports in which incomplete or no financial presentations are made (see Statement on Auditing Procedures No. 33, Chapter 13, paragraphs 9 and 10).

11. This Opinion does not supersede any prior pronouncement of the American Institute of Certified Public Accountants relating to disclosure requirements.

Content

12. Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

- a. A selection from existing acceptable alternatives;
- b. Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry;
- c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

13. Examples of disclosures by a business entity commonly required with respect to accounting policies would include, among others, those relating to basis of consolidation, depreciation methods, amortization of intangibles, inventory pricing, accounting for research and development costs (including basis for amortization), translation of foreign currencies, recognition of profit on long-term construction-type contracts, and recognition of revenue from franchising and leasing operations. This list of examples is not all-inclusive.

14. Financial statement disclosure of accounting policies should not duplicate details (e.g., composition of inventories or of plant assets) presented elsewhere as part of the financial statements. In some cases, the disclosure of accounting policies should refer to related details presented elsewhere as part of the financial statements; for example, changes in accounting policies during the period should be described with cross-reference to the disclosure required by APB Opinion No. 20, Accounting Changes, of the current effect of the change and of the pro forma effect of retroactive application.

Format

15. The Board recognizes the need for flexibility in matters of format (including the location) of disclosure of accounting policies provided that the reporting entity identifies and describes its significant accounting policies as an integral part of its financial statements in accordance with

the foregoing guides in this Opinion. The Board believes that the disclosure is particularly useful if given in a separate Summary of Significant Accounting Policies preceding the notes to financial statements or as the initial note. Accordingly, it expresses its preference for that format under the same or a similar title.

30. SOP 94-6 provides the following guidance:

Introduction

.01 The volatile business and economic environment underscores a need for improved disclosure about the significant risks and uncertainties that face reporting entities. In 1987, the AICPA issued the Report of the Task Force on Risks and Uncertainties (the Report), which was intended to help standards setting bodies and others identify practical methods of improving the information communicated to users of financial statements to help them assess those risks and uncertainties. This Statement of Position (SOP) is largely based on the Report. The central feature of this SOP's disclosure requirements is selectivity: specified criteria serve to screen the host of risks and uncertainties that affect every entity so that required disclosures are limited to matters significant to a particular entity.

.02 The disclosures focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties this SOP deals with can stem from the nature of the entity's operations, from the necessary use of estimates in the preparation of the entity's financial statements, and from significant concentrations in certain aspects of the entity's operations.

Scope

.03 This SOP applies to financial statements prepared in conformity with generally accepted accounting principles (GAAP) applicable to nongovernmental entities. It applies to all entities that issue such statements¹ While this SOP applies to complete interim financial statements, it does not apply to condensed or summarized interim financial statements. If comparative financial statements are presented, the disclosure requirements apply only to the financial statements for the most recent fiscal period presented.

¹ However, see *Accounting Principles Board (APB) Opinion No. 28, Interim Financial Reporting*, paragraph 30, for guidance on disclosure of contingencies in summarized interim financial information of publicly traded companies.

.04 The disclosure requirements do not encompass risks and uncertainties that might be associated with management or key personnel, proposed changes in government regulations; proposed changes in accounting principles,² or deficiencies in the internal control structure. Nor do they encompass the possible effects of acts of God, war, or sudden catastrophes.

Relationship to Other Pronouncements

.05 The disclosure requirements of this SOP in many circumstances are similar to or overlap the disclosure requirements in certain pronouncements of the Financial Accounting Standards Board (FASB), such as *FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies*, and, for public business enterprises, FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*. The disclosure requirements of this SOP in many circumstances also are similar to or overlap the disclosure requirements in certain pronouncements of the Securities and Exchange Commission (SEC). This SOP does not alter the requirements of any FASB or SEC pronouncement.

.06 Certain disclosure requirements in this SOP supplement the requirements of other authoritative pronouncements. In many cases, however, the disclosure requirements in this SOP, particularly those relating to certain significant estimates, will be met or partly met by compliance with such other pronouncements.

Definitions

.07 This SOP uses the following terms with the definitions indicated:

Near term. A period of time not to exceed one year from the date of the financial statements.

Severe impact. (Used in reference to current vulnerability due to certain concentrations. See paragraph .21.) A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material,³ yet they may not be so significant as to disrupt the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity's capital stock or its debt securities, but they would not necessarily have a severe impact on (disrupt) the enterprise itself. The concept of severe impact, however, includes matters that are less than catastrophic.⁴

² SEC Staff Accounting Bulletin 74 requires disclosure, both in Management's Discussion and Analysis (MD&A) and in the notes to the financial statements, concerning accounting standards that have been issued but that have not yet been adopted. Also, Auditing Interpretation No. 3 of SAS No. 1, section 410, "The Impact on an Auditor's Report of an FASB Statement Prior to the Statement's Effective Date" (AICPA, *Professional Standards*, vol. 1, AU section 9410.13-.18) addresses reporting considerations when financial statements will have to be restated in the future because an authoritative accounting pronouncement that is not yet effective will require retroactive application of its provisions by prior-period adjustment.

³ *FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information*, defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

⁴ Matters that are catastrophic include, for example, those that would result in bankruptcy.

Conclusions

.08 The Accounting Standards Executive Committee (AcSEC) Of the AICPA has concluded that reporting entities should make disclosures in their financial statements beyond those now required or generally made in financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

- a. Nature of operations
- b. Use of estimates in the preparation of financial statements
- c. Certain significant estimates
- d. Current vulnerability due to certain concentrations

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly; the disclosures required by this SOP may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

.09 The following detailed discussion of the four areas of disclosure enumerated in paragraph .08 should be read in conjunction with the "Illustrative Disclosures" in appendix A [paragraph .27] of this SOP, which provide guidance for implementing them.

Nature of Operations

.10 Financial statements should include a description of the major products or services the reporting entity sells or provides and its principal markets including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination for

example assets, revenues, or earnings. Not-for-profit organizations' disclosures should briefly describe the principal services performed by the entity and the revenue sources for the entity's services. Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as predominately, about equally, or major and other.⁵

Use of Estimates in the Preparation of Financial Statements

.11 Financial statements should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates.

Certain Significant Estimates

.12 Various accounting pronouncements require disclosures about uncertainties addressed by those pronouncements. In particular, paragraphs 9-12, and 17.b. and footnote 6 of FASB Statement No. 5 specify disclosures to be made about contingencies⁶ that exist at the date of the financial statements. The disclosure requirements of paragraphs 9-12 of Statement No. 5 are further clarified in *FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss*. In addition to disclosures required by FASB Statement No. 5 and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below

⁵ See paragraph B-17 in appendix B [paragraph .28] for a comparison of this SOP's disclosure requirements concerning nature of operations with the disclosure requirements for public companies in *FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise*.

⁶ FASB Statement No. 5 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a 'gain contingency') or loss (hereinafter a 'loss contingency') to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability."

.13 Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

- a. It is at least reasonably possible⁷ that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

⁷ The term reasonably possible is used in this SOP consistent with its use in FASB Statement No. 5 to mean that the chance of a future transaction or event occurring is more than remote but less than likely.

- b. The effect of the change would be material to the financial statements.

.14 The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible⁸ that a change in the estimate will occur in the near term.⁹ If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

⁸ The words reasonably possible need not be used in the disclosures required by this SOP

⁹ FASB Statement No. 5 states in paragraph 17.b .that “adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization”

.15 Many entities use risk-reduction techniques to mitigate losses or the uncertainty that may result from future events. If the entity determines that the criteria in paragraph .13 are not met as a result of risk-reduction techniques, the disclosures described in paragraph .14 and disclosure-of the risk reduction techniques are encouraged but not required.

.16 This SOP’s disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of FASB Statement No. 5; rather, the disclosures required under this SOP supplement the disclosures required under Statement No. 5 as follows:

- If an estimate (including estimates that involve contingencies covered by FASB Statement No. 5) meets the criteria for disclosure under paragraph .13 of this SOP, this SOP requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; FASB Statement No. 5 does not distinguish between near-term and long-term contingencies.
- An estimate that does not involve a contingency covered by Statement No. 5, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in paragraph .13. This SOP requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

.17 Whether an estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.

.18 The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

- Inventory subject to rapid technological obsolescence
- Specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Capitalized motion picture film production costs
- Capitalized computer software costs
- Deferred policy acquisition costs of insurance enterprises
- Valuation allowances for commercial and real estate loans
- Environmental remediation-related obligations
- Litigation-related obligations
- Contingent liabilities for obligations of other entities

- Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Amounts reported for long-term contracts

The above list is not intended to be all-inclusive.

.19 The following are examples of events or changes in circumstances that indicate that an estimate associated with the carrying amount of a long-lived asset may be particularly sensitive to change in the near term:¹⁰

- a. A significant decrease in the market value of an asset
- b. A significant change in the extent or manner in which an asset is used
- c. A significant adverse change in legal factors or in the business climate that affects the value of an asset
- d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset
- e. A history of losses associated with an asset, a projection or forecast (if either is available) that demonstrates continuing losses associated with an asset, or both

¹⁰ On November 29, 1993, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, Accounting for the Impairment of Long-Lived Assets. This list was derived from the list in the FASB exposure draft of examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of a long-lived asset should be assessed for impairment. Any final Statement may contain additional or revised examples.

Current Vulnerability Due to Certain Concentrations

.20 Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

.21 Financial statements should disclose the concentrations described in paragraph .22 if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

- a. The concentration exists at the date of the financial statements.
- b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

.22 Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph .21. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

- a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For

purposes of this SOP, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.

- b. Concentrations in revenue from particular products, services, or fund-raising events. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.
- c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.
- d. Concentrations in the market or geographic area ¹¹ in which an entity conducts its operations. The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this SOP, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

¹¹ FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, paragraph 34, provides guidance on determining foreign geographic areas

.24 Disclosure of concentrations meeting the criteria of paragraph .21 should include information that is adequate to inform users of the general nature of the risk associated with the concentration. For those concentrations of labor (paragraph .22c) subject to collective bargaining agreements and concentrations of operations located outside of the entity's home country (paragraph .22d) that meet the criteria of paragraph .21, the following specific disclosures are required:

- For labor subject to collective bargaining agreements, disclosure should include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.
- For operations located outside the entity's home country, disclosure should include the carrying amounts of net assets and the geographic areas in which they are located.

Adequate information about some concentrations may already be presented in diverse parts of the financial statements. For example, adequate information about assets or operations located outside the entity's home country may be included in disclosures made to comply with FASB Statement No. 14. In accordance with paragraph .08 of this SOP, such information need not be repeated.

Application of Disclosure Criteria

.25 An assessment of whether a disclosure is required should not be found to be in error simply as a result of future events; For example, reporting a concentration not followed by a severe impact does not imply that the disclosure should not have been made, because something that has only a reasonably possible chance of occurring obviously might not occur. Similarly, the occurrence of a severe impact related to a concentration not disclosed in the prior-year financial statements would not suggest noncompliance with this SOP's requirements if an appropriate judgment had been made that a near term severe impact was not at least reasonably possible at the prior reporting date. In addition, a severe impact may arise from a concentration of which management did not have knowledge at the time the financial statements were issued.

31. SOP 94-5 provides the following guidance:

Introduction

.01 Most of the accounting principles related to disclosures for insurance enterprises were promulgated over twenty years ago when the insurance regulatory and business environments were less complex and volatile. Accordingly, the AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required in insurance enterprises' financial statements. This statement of position (SOP) is a result of that project.

.02 This SOP applies to annual and complete sets of interim financial statements prepared in conformity with generally accepted accounting principles (GAAP) of life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. Furthermore, AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, *Professional Standards*, vol. 1, AU section 9623.60.79), requires auditors to apply the same disclosure criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.

Relationship to Other Pronouncements

.03 In some circumstances, the disclosure requirements in this SOP may be similar to, or overlap, the disclosure requirements in certain other authoritative accounting pronouncements issued by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), and the Securities and Exchange Commission (SEC). For example—

- *FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies*, requires certain disclosures related to loss contingencies, including catastrophe losses of property and casualty insurance companies.
- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*, requires certain disclosures about liabilities for unpaid claims and claim adjustment expenses and statutory capital.
- *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, requires certain disclosures about reinsurance transactions.
- *AICPA Statement of Position 94-6, Disclosure of Certain Significant Risks and Uncertainties* requires disclosures about certain significant estimates.

The SEC Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*, requires disclosures of information about liabilities for unpaid claims and claim adjustment expenses.

The disclosure requirements in this SOP supplement the disclosure requirements in other authoritative pronouncements. This SOP does not alter the requirements of any FASB or SEC pronouncement.

Conclusions

.04 The disclosure requirements in this section should be read in conjunction with appendix A, "Illustrative Disclosures" [paragraph .13], and appendix B, "Discussion of Conclusions" [paragraph .14], of this SOP.

Permitted Statutory Accounting Practices

.05 Insurance enterprises currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The National Association of Insurance Commissioners (NAIC) currently

has a project under way to codify statutory accounting practices through a complete revision of its *Accounting Practices and Procedures Manuals*, that, when complete, is expected to replace prescribed or permitted statutory accounting practices as the statutory basis of accounting for insurance enterprises (referred to hereafter as the "codification"). Therefore, the codification will likely result in changes to what is currently considered a prescribed statutory accounting practice. Furthermore, postcodification permitted statutory accounting practices will be exceptions to the statutory basis of accounting.

.06 Prescribed precodification statutory accounting practices include state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state, NAIC *Annual Statement Instructions*; the NAIC *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiners' Handbook*.

.07 Permitted statutory accounting practices include practices not described in paragraph .06 but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of their statutory financial statements (a) when the enterprise wishes to depart from the prescribed statutory accounting practices, or (b) when prescribed statutory accounting practices do not address the accounting for the transaction.

.08 The disclosures in this paragraph should be made for permitted statutory accounting practices for the most recent fiscal year presented regardless of when the permitted statutory accounting practice was initiated. Insurance enterprises should disclose the following information about permitted statutory accounting practices that individually or in the aggregate materially affect statutory surplus or risk-based capital, including GAAP practices when the permitted practices differ from the prescribed statutory accounting practices:

- a. A description of the permitted statutory accounting practice
- b. A statement that the permitted statutory accounting practice differs from prescribed statutory accounting practices
- c. The monetary effect on statutory surplus

Insurance enterprises should disclose the following information about permitted statutory accounting practices, excluding GAAP practices used when prescribed statutory accounting practices do not address the accounting for the transaction:

- a. A description of the transaction and of the permitted statutory accounting practice used
- b. A statement that prescribed statutory accounting practices do not address the accounting for the transaction

APPENDIX A

Illustrative Disclosures

A-1. The illustrations included in this appendix are guides to implementation of the disclosures required by this SOP. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative disclosure presentations are permissible if they satisfy the disclosure requirements of this SOP.

Permitted Statutory Accounting Practices

A-2. The following is an illustration of disclosures that an insurance enterprise would make before the codification is complete, to meet the requirements of paragraph .08 of this SOP.

Note X. Permitted Statutory Accounting Practices

Property and Casualty Company, Inc., domiciled in ABC State, prepares its statutory financial statements in accordance with accounting practices prescribed or permitted by the ABC State Insurance Department. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.

The company received written approval from the ABC State Insurance Department to discount loss reserves at a rate of X percent for statutory accounting purposes, which differs from prescribed statutory accounting practices. Statutory accounting practices prescribed by ABC state require that loss reserves be discounted at Y percent. As of December 31, 19X3, that permitted transaction increased statutory surplus by \$XX million over what it would have been had prescribed accounting practice been followed.

RELEVANT LITERATURE**Statutory Accounting**

- NAIC Annual Statement Instructions
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies*
- *Accounting Research Bulletin No. 43, Chapter 2A, Form of Statements – Comparative Financial Statements*
- *AICPA Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties*
- *AICPA Statement of Position No. 94-5, Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*

State Regulations

- No additional guidance obtained from state statutes or regulations.