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The Generally Accepted Accounting Principles (GAAP) Statement of Comprehensive Income

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Summary: The GAAP Statement of Comprehensive Income will trace all source income, including direct adjustments to surplus. Since many insurance company decisions are greatly affected by accounting considerations, actuaries will need to know the importance that users of financial statements will place on the statements as well as the effect of various transactions.

Among the items to be discussed will be:
- *What value will financial statement users receive from the Statement of Comprehensive Income? Will it make insurance company financials clearer or just more complicated?*
- *Will rating agencies focus on comprehensive income or net income?*
- *What are some examples of comprehensive income friendly and unfriendly transactions?*
- *Does the difference between income and surplus adjustments matter anymore?*

Mr. Allan W. Ryan: I am with Deloitte & Touche LLP in Wilton, Connecticut. I've been with the firm about eight years and my work involves financial reporting issues and related topics, some audit support, and related consulting. This subject matter hasn't received a lot of attention. This is the first formal session I've seen on it.

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†Mr. Golden, not a member of the sponsoring organization, is Manager at Deloitte & Touche LLP in Wilton.

It should be noted that the proposed accounting procedures are in the form of a financial accounting standard exposure draft, and have not been adopted. This standard looks at GAAP income and other items that are separately identified as income, such as realized capital gains and losses. It also brings in adjustments that don't go through the income statement, including Statement of Financial Accounting Standards (*SFAS) 115* adjustments.

Our first speaker Russell Golden, not a member of the Society, is also with the firm of Deloitte and Touche LLP. Russell recently moved to our national office in Wilton, Connecticut. That office deals with questions of practice, interpretation of standards, and related issues that arise within our firm. This involves real life situations and a substantial amount of research. He will give an update on the status of this exposure draft and its impact on financial reporting. This will include the rationale behind its development.

Our second speaker, Joel Salomon, recently left Moody's Investors Service where he was an insurance analyst. He's now a vice president with Swiss Re. His perspective is going to be from his prior employer, as one of the rating agencies. He will give us an idea of what it means from a rating agency's point of view.

Mr. Russell G. Golden: I'm a manager in Deloitte & Touche's accounting research department. The accounting research department has three main functions. The first function is to support the practice offices' accounting questions. Many questions are a result of items that have not been addressed by our offices over the firm. Our second function is to take those questions and turn them into accounting policies for the firm. The third function is to follow the accounting standards—the FASB Standards, the Accounting Standards Executive Committee (ASEC), and the SEC. One of the things that I've been doing the last year or so is following the proposed FASB statement on comprehensive income. I want to spend a few minutes talking about what the standard entails. Hopefully I can illustrate how it's going to affect the users and then talk a little about the status of this proposed FASB.

The FASB Statement on Comprehensive Income was added to the agenda in September 1995, as a result of many different standards requiring companies to put the effect of items within equity. Perhaps the most common and the most recent was *SFAS 115*, Accounting for Certain Investments in Debt and Equity Securities. I am sure you are aware that *SFAS 115* talks about three things—held to maturity, available for sale, and trading securities. Available for sale classification is the classification that you mark to market and your debit or credit goes through equity. That is really what comprehensive income is—items that are income, but because the accounting standards don't force you to take it against the profit and loss (P&L) statement you run it into equity.

Comprehensive income was introduced in Conceptual Statement Three, which has been later superseded by Conceptual Statement Six, Elements of Financial Statements. The definition of comprehensive income is the change in equity or net assets of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. If you think about what that definition is, it includes income because income is going to increase or decrease net assets but is not an owner source.

Comprehensive income is income plus the other items that are booked through equity that decrease assets and do not relate to owner sources. The two things that relate to owner sources are going to be capital infusions and dividends or capital of distributions.

The proposed SFAS was added to the agenda in September 1995, and the FASB released an exposure draft in July 1996. The only thing they changed between the original exposure draft and the final draft was the removal of comprehensive earnings per share.

The proposed statement applies to all entities that release financial statements. The purpose of the standard is to illustrate to the users what amounts or changes in net assets are nonowner sources. It really doesn't change how one accounts for anything nor how one computes anything. All the information that is there will be there tomorrow; it's just going to be in a different format. All that information right now is in the equity statement. The standard merely takes the information already in equity and requires it to be in a new statement or identified as comprehensive income within equity.

Companies will be required to identify comprehensive income for all periods, including interim periods. The statement will start with net income and have four potential components: foreign currency, the minimum pension liability, any type of future contracts, and *SFAS 115,* investments that are classified as available for sale. In the future, and depending on how the FASB determines the new derivative standard, hedging may be the fifth component.

When reporting comprehensive income it should be displayed in the same prominence as other financial statements. In other words, it cannot be included in the notes of the financial statements. It must be included on an actual financial statement. It can be displayed either net of tax or it can have one line item that has the tax. For example, if an *SFAS 115* appreciation exists, one could either state the total amount was $1 million, one could show $1 million with a net tax number below the line, or one could show it at $700,000, which would be net of tax. Any of these ways is appropriate.

Like I said before, financial statements of companies that release interim financial statements and public companies that release Form 10-Qs will be affected by this statement. The effective date will be for the fiscal year beginning after December 15, 1997, and early adoption is appropriate, but it's not necessarily encouraged. I don't think too many entities will go ahead and adopt the standard early.

How is this going to affect anything? I said before it doesn't change how one computes or how one accounts. All it changes is how you present what's already been accounted for. I think that's a real important thing to think about. All the information is there. What type of value would this standard possibly get? When you step back and understand what the users need and why, you understand that the users need to know what has occurred and what truly affects income. If you think about the *SFAS 115*, the entity has made an investment in some type of debt or equity security that has appreciated or depreciated. That has occurred in a specific period, and they now have a greater right or lesser right to that investment. To me that's income. But because the *SFAS 115* did not require these effects to be recorded through the P&L, it's not specifically shown as income. The users do not always realize that the company has a greater right to cash from that investment. They do not realize the entity has earned or lost something related to that investment. I think that's a real important aspect to remember, and that is the fundamental reason why the FASB has proposed and will eventually release a final statement on comprehensive income.

Another problem is, that some people will confuse comprehensive net income with net income. You may have companies that have a fairly low net income figure, but have done well in the foreign currency market. These companies would have a low net income figure but a high comprehensive income figure. I think users, specifically in investment analysis, will need to focus on both the net income figure and the comprehensive income figure.

The other problem is it may suggest that a comprehensive income figure is a more superior measure then just net income. That's something that our firm, other firms, and users of financial statements have expressed in their comment letters to the FASB. That is one of the reasons why the comprehensive earnings per share figure was taken out. I believe we want to focus on both net income and comprehensive income.

As I said before, there really is no change in how you compute or how you calculate any of the amounts within comprehensive income; it is how you present. Initially, you presented these items within equity. Now you will identify them as comprehensive income either within equity or in their own stand-alone financial

statement that has to be given the same prominence as the balance sheet, and the income statement.

Mr. Joel Steven Salomon: As Allan mentioned, I've moved on from Moody's to Swiss Re and because of that I haven't really kept up with all the changes that have occurred within the last month or two. As Russ mentioned, I think there are a few important changes that have been made recently. One is that there will be no comprehensive income per share stated, and I think from a user perspective that's a clear positive. Also, I think the term "comprehensive income" is a misnomer being that the term itself is not required. Again, because it's a misnomer, I think that's clearly beneficial. Another point to make is that the FASB won't pursue a different or discreet financial statement for comprehensive income. The preparer will have the option to include it, as Russ said, in a statement of changes in equity. It won't be in bright lights as the original exposure draft had stated.

Most of what I'm going to be discussing applies to mutual insurance companies as well because of GAAP for mutuals. Finally, I think it would be helpful for everyone for me to answer one of the questions that was in the program: Will rating agencies focus on comprehensive income or net income? Do you think that the rating agencies will focus on comprehensive income? How about net income? For all of you who answered yes, the answer is neither. I'll get into the reason for that.

Here is a brief overview: Rating agencies look for predictability in earnings and to focus on the true economic value of earnings. I'll discuss the value of GAAP-based financial comparing GAAP to statutory accounting and some of the benefits of GAAP. Then I'll specifically get into the comprehensive income statement, including some of the background and some of the options. I will conclude with the effect on credit analysis and the impact on credit ratings; specifically insurance financial strength ratings from a Moody's perspective or the claims paying ability ratings, as the term is used, by the other rating agencies.

In general, the objective of credit analysis is to forecast the ability of borrowers to meet their debt obligations when they come due. It's a very broad statement and it doesn't pertain specifically to any insurance company, but policyholder claims will clearly be included in obligations. Credit analysis focuses on cash flows: Do insurers have sufficient funds to meet their obligations? Obviously capital adequacy is important, but liquidity is considered just as important. In fact, for short-term obligations (suppose the insurer has an obligation for one year or less), rating agencies would say that liquidity is actually more important than the long-term view of capital adequacy.

At Moody's, unlike some other rating agencies, forecasting the size and the predictability of cash flows begins and ends with a qualitative assessment of factors. Mike Mackenzie discussed CAMEL and CARAMEL, capital adequacy, asset quality, reinsurance and actuarial liability calculations, management quality, earnings, and liquidity in the general session. Those are mainly quantitative items. At Moody's the balance is weighted more toward the qualitative. Those items include franchise value and brand name recognition. They also include questions such as: What are the types of products that a company is selling? How are those products being distributed? Are they being distributed through a bank, a broker/dealer, an independent agency, or a career agency? Who are the buyers of those products? Is the money likely to move quickly? What's the target market? Most importantly, or one of the most important items, is the management strategy and their vision for the future.

Clearly it's very difficult, as you all know, to be able to project obligations 30 years out. That's the reason why the emphasis is more on the qualitative then the quantitative. There is a quantitative picture of the insurer that is formed. Within capital adequacy, the ratios analyzed by rating agencies include their own internal risk-adjusted capital ratios. They also look at the NAIC risk-based capital ratio. They'll also analyze a capitalization ratio.

For asset quality, which is clearly a very important part of the analysis, a company will be analyzed for its below-investment-grade bonds, the percentage of assets and capital they represent, the underperforming mortgage loans, and so on. A lot of detail goes into the quantitative measures. But the weighting, at least at Moody's, is more towards the qualitative. The reported financial information is used only as a starting point; it's not the end point. Many people think that's what the users use to make their assessments. In actuality, it's just a starting point to determine the true economic values of the company. There are many adjustments that have to be made to the accounting to get to cash flow and develop the true economics. The accounting is also used to compare the company now to where it was in the past and where it will be in the future. It is also compared with other industry peer group members.

Yes, it's important to understand that the variability of an insured's cushion to meet its obligations can be just as important as the level of that obligation, so predictability is clearly important. How predictable those values are is a function of the company's ability to generate cash flow. For that, a rating agency will look at the liquidity of a company's assets: its new premium generation and recurring premium generation and cash outflows, such as surrenders and death benefits. The predictability also depends on secondary liquidity sources (such as lines of credit, bank loans, and management's ability to react quickly and in a focused way to

adverse situations). The actions of regulators and the support of a parent company or a third party also need to be considered.

Up until now I've been talking mostly about the true economics and cash flows. I'm going to shift the focus from economics and cash flows to accounting. I'll compare statutory and GAAP accounting and then I'll get into the comprehensive income statement specifically. First, the statutory accounting practices obviously vary by state. Thus, there's the potential for different accounting methods to complicate credit analysis. Second, statutory accounting's emphasis on solvency tends to understate value creation and capital generation. Obviously there is less of a focus on the earnings and more of a focus on the solvency of a company.

GAAP tends to reduce the broad differences in accounting methods. Credit analysis does recognize that even when accounting methods are uniform between companies, the reported data must be carefully analyzed. You need to go beyond just looking at the results and look at the underlying assumptions that a company uses to arrive at the true economics.

I'll explain the benefits of GAAP reporting from a credit analysis point of view. First of all, it's viewed as a more comprehensive basis of comparing operations and financial position with other financial institutions, such as banks, mutual fund companies, and broker/dealers. Second, the increased disclosure requirements for GAAP will provide analysts with additional information. There may be additional information on derivatives, for example, that is not currently available in statutory statements.

Furthermore, many financial statement users (here I am talking mostly about the equity analysts) are unaccustomed to statutory accounting practices, so the availability of GAAP will give them more confidence in the financial statements of an insurance company. It also may lead to broader access to the capital markets because of this increased confidence. I guess this is somewhat related to the development of the mutual insurance holding company, which gives mutuals access to not only the debt markets, but the equity markets as well.

I'd like to go through some of the credit issues raised by GAAP. Reported results are clearly more subjective then the clearly defined statutory accounting rules, especially in the amortization of deferred policy acquisition costs and the amortization of goodwill. There's also the possibility that there may be a reduction in pricing flexibility because of the heightened focus on profitability over a shorter cycle. Historically there has been this long-term focus on solvency (in statutory accounting). Now the shift to GAAP accounting will focus more on the earnings of a company as opposed to its capital position.

Additional issues that are raised by GAAP include the potential shift in portfolio strategy. Some companies have changed the way they're strategizing for portfolio management because of the equity volatility caused by *SFAS 115* (the marking-to-market of certain debt and equity securities). There's also the potential for a change in management culture and compensation systems that reward short-term performance as opposed to the long-term performance. Some additional issues that are raised by GAAP include the fact that there's a large number of estimates embedded in the financial statements. Credit analysts realize this and they ask questions about the underlying assumptions on the various products that a company sells. The comparability is somewhat limited by differences in the implementation of the numerous accounting principles, *SFAS 60, 97,* and now *SFAS 120*. It is also limited because of the amount of information available—roughly only two years—but there is a clear focus and analysis of the experience assumptions for lapses, mortality, expenses, and interest rates.

I'd like to focus specifically on the comprehensive income statement. Clearly it requires companies to report nonowner changes in equity directly in equity items. It divides comprehensive income into net income and other comprehensive income items. The most common items will generally be foreign currency translation, the minimum pension, and unrealized capital gains and losses on available for sale securities due to *SFAS 115*. I think it's very important to note that these items are already available in the financial statements, the notes, and the statement of equity. It's just a reconfiguring of information that's already available. If you're a good analyst you should have gotten to this number already. I'll get to what that means a little later.

The original exposure draft discussed three different items. This is the most recent information, I found over the last two months: "There have been modifications to the exposure draft and the modified approach requires comprehensive income to be reported in a financial statement that is displayed with the same prominence as other financial statements (I think Russell commented on this too) thereby permitting an enterprise to display the components of all the comprehensive income below the total for net income in an income statement, or in a separate statement that begins with net income, or in a statement of changes in equity." Clearly there are three options, and I think those are stated here.

What are the effects of comprehensive income? I think the biggest effect will be the *SFAS 115* effect of available for sale securities, which are a function of interest rate changes. Obviously if interest rates are not volatile, you're unlikely to have major movements in available for sale values. But if that's not the case, I think that the *SFAS 115* effect is probably likely to be one of the major effects along with the foreign currency translation. The minimum pension liability is likely to be the

smallest of those major items. Russ mentioned that the effect of futures may be somewhat larger on companies that are doing a lot of derivative transactions.

I think it's important to point out here that credit analysts back that amount out (the effect of *SFAS 115* on equity) because of the changes in market value of assets and not the changes in market value of liabilities, so even though it's included in comprehensive income, they may just back that out also.

The comprehensive income also allows more transparency for credit analysis. But I think it's important to emphasize the point that I made early in the presentation that the focus is on the true economics and cash flow. It's unlikely to affect the insurance financial strength or claims paying ability ratings of insurance companies. Again, the focus is on the economics and not on net income or comprehensive income.

To conclude, GAAP financials and the comprehensive income statement complement statutory accounting and statutory financial information. They won't be replaced. I think credit analysts will continue to look at both statutory and GAAP financials. This is a question that was raised in a subject related to GAAP from mutuals now that GAAP is available for mutual insurance companies: Are you just going to focus on statutory statements? That won't be the case. Don't anticipate rating changes just because of the new comprehensive income financial statement. I think that's the bottom line. GAAP does expose some companies' problems earlier then statutory because of asset valuation issues. But again, I don't think that's going to be a ratings issue.

Mr. Ryan: In a way this is almost a nonevent. Russell made the comment that there have been no substantive changes in accounting rules or procedures. It's simply a new way of presenting things. Joel, I think the analysts are smart enough to see this, as they're looking for the real economics and nothing has changed. It should also be emphasized that this is a pronouncement that's not specific to insurance companies. This is a general GAAP pronouncement, is that correct?

Mr. Golden: Yes, any company that has comprehensive income will be required to display it. Manufacturing companies that have investments that have foreign currency transactions or any other companies will have to adopt the standard.

Mr. Ryan: I do not believe there are specific references to the insurance industry in this statement.

Mr. Golden: I don't think there are.

Mr. Ryan: Therefore if a mutual insurance company wants to have a GAAP opinion, it would have to comply.

Mr. Golden: Right.

Mr. Roger Eugene Frost: With this extra component to income that someone is going to be looking at, was it taken into account when GAAP taxes were calculated or are we just adding the income without showing the tax effects?

Mr. Golden: There are two ways one can show the tax effects on comprehensive income. One could show all the comprehensive income levels at a gross level, and then have one line item that says tax effect. Or one can show each line item net of tax. I have a draft copy of the final statement that has some illustrations as to how one would display it. The standard shows both types.

Mr. Ryan: Again, it won't change overall GAAP tax numbers?

Mr. Golden: No.

Mr. Philip J. T. Cernanec: Being one of those companies moving towards GAAP, I'm going to ask you to think down a step further. It seems as if the statement of comprehensive income takes some things that companies, when looking at GAAP information, might separate by business unit. But when they aggregate to incorporate the change in equity, it doesn't get into that line of business or business unit information. Is it going to take companies into an environment where the comprehensive income statement will be done at line of business and business units, so that some of these items might actually get out there closer to where the business is actually managed rather than in the corporate line approach?

Mr. Golden: It may. Many times I see companies manage their business one way and then, at the end, they bring everything up to the corporate line. We have to do financial reporting, and the financial reporting aspect has absolutely nothing to do with how they manage their business. Many people have the concept that GAAP is for external use only. We shouldn't manage our businesses that way.

Mr. Cernanec: Goodwill amortization sometimes gets through the corporate line as the industry is looking at increased activities in the mergers and consolidation and acquisition line. Do you have a perception as to whether this is going to possibly accelerate a realization that some of those acquisitions in goodwill might be set up on some fairly aggressive basis?

Mr. Golden: When you say fairly aggressive, do you mean they may try to defer it over a shorter time frame?

Mr. Cernanec: Actually it's the difference between the purchase price and the valuation of the business that gets set up as a goodwill. The standards by which that goodwill is set up are based on the purchase price and the valuation of the business. It's set up differently. If the value of the business does not quite materialize, it may get to the point where the aggressiveness of that level of goodwill relative to your stock value might be something that's a bit higher than where the stock might have been valued at one point in time.

Mr. Golden: That's a good question, because in the way that you compute goodwill you're right. One computes a purchase price, and a consideration given for the fair value of the assets/liabilities one receives, and that difference goes to goodwill. Fair value of the assets/liability you receive should not be any different before or after the statement. The fair market value of what you gave, specifically if you gave stock, could be different depending on how the marketplace views the comprehensive income statement. With respect to the amortization of the goodwill period, I think that this will not have any effect over how long you amortize your goodwill. I know the SEC is always looking to have a shorter amortization period. There's also on the FASB Statement a reconsideration of *Actuarial Practices Bulletin (APB) No. 16*, and they may address or change the way that we account for both purchase business combinations and pooling of interests business combinations. We're watching that very closely, as is everybody else.

From the Floor: With respect to the unrealized capital gains or loss adjustment, is that the net effect of the associated deferred acquisition cost (DAC)? And if it is, do you have to disclose in the notes the components?

Mr. Ryan: I believe that under *SFAS 115*, the net effect would first be the unrealized gain or loss. Then you would have an offsetting effect if there was a DAC adjustment in equity as well. You'd have a further one for the deferred tax liability. In some cases the net impact could be close to zero, depending on how the numbers fall out. I think there is some freedom on how you present this in the financial statements, whether you just show one net number or you show the components.

Mr. Salomon: I've seen companies that have shown it net and others that have disclosed each item.

Mr. Golden: All the standard will do is change the wording of *SFAS 115* from "needs to be disclosed in a separate component of stock owner equity," to "needs to

be disclosed as a separate component of comprehensive income." That does not change how you compute and report *SFAS 115* adjustments. The only change is where you disclose the amount.