

**PRIMARY CONSIDERATIONS
OF A POLICY DECISION REGARDING
THE FUTURE OF STATUTORY ACCOUNTING & FINANCIAL REPORTING**



On April 21, 2010, the Statutory Accounting and Financial Reporting Subgroup of the Solvency Modernization Initiative (EX) Task Force highlighted the primary questions for the Subgroup's charge as:

1. What should be the purpose of the regulatory accounting model?
2. Given that the IAIS and major jurisdictions are advocating the use of IFRS (possibly with modifications) for regulatory purposes, should the NAIC continue to maintain an entire codification of statutory accounting?
3. Should regulatory financial statements be utilized for public purposes or should a separate public financial filing be required?

NAIC staff was directed to work with the Chairs of the Statutory Accounting Principles Working Group, the International Accounting Standards Working Group, the Emerging Accounting Issues Working Group, the Capital Adequacy Task Force, the Blanks Working Group, the Valuation of Securities Task Force, and actuarial groups, to draft a list of the primary considerations points and the positive and negative implications of each consideration point.

Background

In 2002, the FASB and the IASB signed the Norwalk Agreement formalizing their commitment to the convergence of U.S. and international accounting standards. Since that time several steps towards this goal have been taken. In addition, the boards are currently working on several joint projects including: **Insurance contracts, Accounting for Financial instruments, Consolidations (including special purpose entities), Financial Statement Presentation, and Revenue Recognition.**

The SEC has a Roadmap for IFRS. Though much remains uncertain, the SEC made clear that it envisions 2015 as the earliest possible date for the required use of IFRS by U.S. public companies. The SEC action calls for more study of IFRS and a 2011 vote on whether to move ahead with a mandate to use IFRS. And perhaps most importantly for issuers, auditors and other stakeholders hungry for signs of which way the commission might be leaning, the SEC directed its staff to publish periodic progress reports, starting no later than October, which will be available to the public. (Journal of Accountancy).

Current use of IFRS in other countries

Note that IFRS is a principles based accounting model that is in wide use internationally; however not all jurisdictions have adopted IFRS as adopted by the IASB, but rather have adopted IFRS with modifications specific to the jurisdiction. *Per Deloitte IAS Plus website: <http://www.iasplus.com/country/useias.htm>.*

Of the 122 jurisdictions (25 + 6 + 91) that permit or require IFRSs for domestic listed companies:

- In 89 jurisdictions the audit report refers to conformity with IFRSs
- In 30 jurisdictions the audit report refers to conformity with IFRSs **as adopted by the EU**
- In 1 jurisdiction (South Korea) the audit report refers to local GAAP
- In 1 jurisdiction (Hong Kong) the audit report for companies incorporated in Hong Kong refers to local GAAP and for companies incorporated elsewhere it refers to IFRSs
- For 1 jurisdiction (Japan) this has not yet been announced

IFRS is International GAAP. It would fall into the definition of Public Market Accounting described below. It is developed by the International Accounting Standards Board, with members from around the world. Current US membership is 4 out of 15 members. It is designed for general purpose financial statements using a principles based approach, so it allows for considerable judgment and a significant amount of optionality, which tends to reduce the comparability of financial statements. It also has significantly less industry specific guidance than current US GAAP. As noted above, several areas which are significant to insurers are current joint projects of the IASB and the FASB.

There are approximately 6,695 risk bearing insurers in the U.S. As of 2009, 193 public holding companies that are affiliated to 1,615 insurers filing to the NAIC representing \$981 billion or 61% of total direct written premium. Fourteen of the 20 largest insurers by direct premium have publicly traded parent companies. These public holding companies file US GAAP financial statements with the SEC etc. GAAP statements are typically on a consolidated group level. They also file on a statutory legal entity basis with state regulators. Therefore publicly traded U.S. insurers are filing both public GAAP statements and statutory statements. This leaves a significant number of private insurers that do not file on a U. S. GAAP basis. Most private insurers are only filing and being audited on a statutory basis. Not included in the numbers above are Risk Retention Groups. As of year end 2009, there were 164 out of 236 RRG's filing on a basis other than SAP.

U. S. statutory accounting is specified by laws and practices prescribed and permitted by the individual states and the Accounting Practices and Procedures Manual. Other state laws utilize the current accounting for purposes of specifying reserving requirements, investment limitations, etc. With limited exceptions, public and private U. S. insurers file statutory accounting financial statements on an individual legal entity basis on a quarterly and annual basis. The annual independent audit opinion on these financial statements is filed in accordance with statutory accounting practices prescribed or permitted by the state of domicile of the insurer. Variations from the state's basis of accounting and the NAIC Accounting Practices and Procedures Manual are disclosed in Annual Statement Note 1 so that companies can be compared. The Accounting Practices and Procedures Manual reflects

the results of the state regulatory review of new U.S. GAAP pronouncements for adoption, adoption with modification or rejection.

1. *What should be the purpose of the regulatory accounting model?*

The purpose of any accounting model should be to communicate relevant financial and nonfinancial information to users of financial statements in a manner that allows such users to make decisions on that information. Accounting is defined by the American Institute of Certified Public Accountants (AICPA) as "the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof." There are various types of accounting models that exist including cash, tax, accrual, public markets accounting, regulatory and liquidation.

Cash Accounting

Cash basis accounting is generally the most basic form of accounting, and commonly used in the smallest businesses. Under this method, income is not counted until cash is actually received, and expenses are not counted until they are actually paid. Under this model, the business owner, suppliers, creditors or small investors consider cash accounting sufficient to make relevant decisions as the business for which the accounting pertains is usually fairly simple.

Tax Accounting

Tax accounting is also commonly used by small businesses and is intended to depict the financial assets, liabilities and operations of a business based upon the tax laws within a particular jurisdiction. Most tax laws are driven by cash transactions, but can be modified and sometimes materially modified in some industries by the taxing authority in order to drive particular behaviors or reflect particular political views on specific issues.

Accrual Accounting

Accrual accounting may be what is most commonly thought of when considering accounting, as it depicts not only the cash received and paid by a business entity, but also the realization of economic events even though cash transactions may not have occurred as of a particular date. The most common example of accrual accounting is generally accepted accounting principles (GAAP), which includes U.S. GAAP and International Financial Reporting Standards (IFRS) as examples. This method of accounting is typically used by entities whose business model may require the use of such a method either for internal purposes (management accounting) or for external purposes (e.g., owners, suppliers, creditors, investors).

Public Markets Accounting

Public Markets Accounting is generally based upon the requirements of local GAAP, but may be further modified in order to incorporate other needs of the public markets (e.g., public investors through organized trading). In most cases these modifications are minor, or are generally more focused on reporting needs (disclosures). Public users (including institutional investors and analysts) have impacted the decisions made by local accounting standard setters over the years, which has led to increased complexity in GAAP accounting and reporting models. The International Accounting Standards Board (IASB) has recently recognized this issue and has created IFRS for small and medium companies.

Regulatory Accounting

Regulatory accounting is used in different industries by regulatory authorities in order to communicate financial and nonfinancial information on their regulated entities in a manner that is most useful to such authorities. Since regulatory accounting is the focus of this section, it is discussed in more detail below under Current US Insurance Regulatory Accounting.

Liquidation Accounting

Liquidation accounting can be required under various situations, including when a regulator views such accounting to be appropriate, but is most commonly thought of as the basis of accounting for an entity that is no longer a going concern (will begin to be liquidated within one year through various means) under U.S. GAAP. This method of accounting results in the business only reporting its net assets in liquidation and any changes therein and does not include its continuing or discontinued operations. This accounting is focused on those amounts that can be currently recovered or are currently expected to be paid out by the business.

Current U.S. Insurance Regulatory Accounting

The current U. S. insurance regulatory accounting model is designed for regulatory use, and one of its primary objectives is protection of the interests of the insurance consumer or customer. The ultimate objective of insurance entity regulation is to ensure that the legal obligations of each individual regulated entity to its policyholders, contract holders and other customers are met when they come due. Consequently the current U.S. insurance regulatory accounting model includes not only accounting principles, but also other aspects of regulation designed to prevent or avoid particular solvency related problems.

U.S. insurance regulatory accounting also includes the concept of conservatism as one of its driving principles, thus creating a financial picture of the entity which helps to provide additional policyholder protection, but also may result in a depiction that does not reflect actual economic results at a given point in time. The other underlying principles are consistency and comparability. The current US regulatory accounting requirements utilize an accrual accounting model, but have much more specificity than virtually any other similar accounting model (specific guidance for insurance industry transactions). The current requirements have many baseline requirements that all insurers are subject to; and it has a significant degree of specialized rules by major product types, i.e., Life, Health Property and Casualty. In addition, there are more detailed accounting and reserving requirements that are specific to more specialized insurance types (credit, title, financial guaranty). Also noteworthy are the conservative reserving rules which are embedded in the accounting requirements, model laws and regulations, and actuarial guidelines.

The current U.S. regulatory accounting model is generally more conservative than U.S. GAAP and less conservative than a liquidation basis of accounting. However, it should be noted that U.S. regulatory accounting works in concert with detailed regulatory reporting as well as other regulatory tools, many of which have been enhanced over the years and which are expected to be further enhanced over future years as regulatory concerns arise. The most noteworthy of such tools is risk-based capital, which is intended to provide a legally established level of capital and surplus for a particular insurer at which point specific regulatory actions should occur, based upon specifically identified risks. One of the major inputs for this determination is the insurer's actual capital and surplus as reported using U.S. Insurance Regulatory Accounting and regulatory financial statements.

Primary points for considering the purpose of future U.S. Insurance Regulatory Accounting:

- Are regulatory rules currently contained within U.S. Insurance Regulatory Accounting (e.g., specific reinsurance contract requirements, affiliated investment and transaction requirements) a necessary part of U.S. Insurance Regulatory Accounting or can such concerns be addressed through various other means (e.g., transaction filings with regulators, separate regulatory reporting or attestations)?
- Is conservatism, the major conceptual difference with GAAP, e.g., nonadmitted assets, necessary for the U.S. insurance regulatory accounting model given the ability to include conservatism in separate regulatory reporting or specific regulatory tools (e.g., RBC, statutes/regulations)?
- Is individual entity reporting rather than consolidated reporting, another major difference with GAAP, necessary for the U.S. insurance regulatory accounting model?
- Should the U.S. insurance regulatory accounting method provide a means to communicate with other regulators (e.g., the Federal Reserve, international insurance regulators) to facilitate the ability of U.S. regulators to adequately question such other regulators regarding the financial condition of holding companies or other entities which have the potential to impact the U.S. insurance legal entities?
- Consideration should be given to whether there is a need for product specific rules as IFRS rules do not reach the level of specificity by insurer type as current US regulatory requirements.
- Consideration should be given to methods that would be employed to ensure comparability.
- Consider if state insurance regulatory needs are the only consideration, or should the needs of others be considered, such as the needs of:
 - Other U.S. regulators, e.g., the Federal Reserve and the SEC
 - International insurance regulators
 - Other international regulators, e.g., banking regulators
 - Non-regulators, e.g., creditors and policyholders

Other related points for consideration:

- Consider the amount of control over the regulatory accounting requirements and whether that is relevant if other regulatory adjustments occur, e.g., to capital requirements and new statutes/regulations that prohibit/limit certain activities, or if separate public vs. regulatory reporting is required.
- Consider the implications for reporting entities that do not currently apply GAAP. Again, some non public insurers are currently SAP only filers. Should there be different bases of accounting and/or reporting requirements for public and nonpublic insurers?
- Consider the impact of current model laws and their interaction with accounting, reserving and capital requirements.
- Consider the impact of any changes to the possible taxation bases of insurers.
- Consider the resource needs for the various options, e.g., some would consider that a large and intensive effort comparable to the original codification project would be needed, depending upon the amount and degree of differences included in the IFRS/GAAP accounting model.
- Consider whether states will continue to have the need or ability to grant state variations and its impact on comparability.
- Consider the impact on various existing regulatory tools.

Points related to statutory reporting for consideration:

- Non-regulatory use of the statutory financial statements results in pressure to make changes to accounting/reporting that are not aligned with regulatory needs/purposes.
- Would making the statutory financial statements confidential ease pressure and still serve the public interests or would a separate public financial statement also be required?
 - Regarding confidential regulatory filings, the implications of state sunshine laws and the need for new or modified statutes.
 - Understanding the variety of users of statutory financial statements.
 - The feasibility and functionality of the separate confidential financial statements, e.g., regulatory reporting in additional tables included in the confidential RBC filings.
- The need for multi- national insurers to be comparable to other non U.S. multi nationals.
- The impact on small to medium U.S. only insurers, which do not currently prepare U.S. GAAP financials.

2. *Given that the IAIS and major jurisdictions are advocating the use of IFRS (possibly with modifications) for regulatory purposes, should the NAIC continue to maintain an entire codification of statutory accounting?*

The current statutory accounting system already includes consideration of any new GAAP pronouncements, whereby the SAPWG decides to reject, adopt or adopt with modifications, such new GAAP provisions for statutory accounting purposes. Under this framework, if GAAP and IFRS converge in the future, then even under the current framework, SAPWG will have to consider the new GAAP/IFRS requirements for application to statutory accounting. This subgroup was formed to consider a direction in lieu of waiting for this SAPWG review to occur under the current framework due to the significant amount of time and work that would be needed to effectuate necessary regulatory changes (e.g., to risk-based capital, accreditation, state statutes and regulations), and to allow the insurance commissioners to consider the policy implications as well as the technical issues involved with this directional decision.

We can consider the options here as a continuum of possibilities. Possible scenarios on the continuum range from A) no changes to Z) complete adoption of IFRS:

A) Freeze SAP without changes: Maintain current SAP for regulatory accounting and decide not to adjust that basis of accounting for any major IFRS/GAAP convergence items. (Note current SAP has already addressed several convergence items)

- Under this option, the accounting base would actually be less responsive to GAAP/IFRS than the current statutory accounting base. For this reason, we have not enumerated the specific issues.

U.S. GAAP with statutory adjustments step by step review: Maintain current SAP for regulatory accounting and decide to adjust that basis of accounting for some (not all) portions of IFRS/GAAP convergence items. This is the current deliberative process in place.

Under this option the following is presumed to represent the regulatory views of specific issues:

- Either regulatory rules currently contained within U.S. Insurance Regulatory Accounting are considered of utmost importance, or the need to retain conservatism within the accounting model used by regulators.
- U.S. insurance regulators have sufficient means to understand IFRS or U.S. GAAP in order to ask the federal reserve and/or international insurance regulators the appropriate questions dealing with the entities they regulate which impact insurers.
- U.S. insurance regulators have sufficient knowledge of IFRS or U.S. GAAP to be able to respond to questions that other regulators (e.g. Federal Reserve, International insurance regulators) have regarding the accounting of U.S. insurers' position within an IFRS or U.S. GAAP financial statement.
- U.S. insurance regulators believe its critical to retain control over their accounting basis in order to be able to respond to issues that occur within the U.S. industry without having to come up with a consensus position at the IAIS and onto the IASB, or to have to deal with differing practices which may occur within a principle-based approach to accounting (IFRS).
- U.S. insurance regulators believe that a recodification of statutory accounting is necessary, and believe that such an effort will take a number of years, and continued existing NAIC staff as well as hiring a consultant to help with such a project is needed. This will require significant NAIC resources but is considered of utmost importance.
- U.S. insurance regulators believe state variations (prescribed and permitted practices) are desirable and necessary, and will continue to require disclosure of such differences.
- By retaining U.S. SAP, public and nonpublic insurers are essentially subject to the same existing SAP requirements, and there is no need to differentiate between public and non public insurers.
- U.S. insurance regulators believe current US regulatory statements and disclosures provide the transparency that is needed where US GAAP, IFRS, and Solvency II do not.
- There is no need to update NAIC model laws which are based upon statutory accounting (e.g. reserving and investment model laws). However, capital requirements may need to be updated regardless given other projects occurring within the Solvency Modernization Initiative.
- Taxation issues of insurers would be less of an issue if the NAIC retained statutory accounting even with modification.

IFRS with statutory adjustments: Abandon the current SAP model and utilize the public IFRS/GAAP accounting model as the primary input, but with limited statutory adjustments, either through a shortened NAIC accounting model and/or through risk-based capital.

Under this option the following is presumed to represent the regulatory views of specific issues:

- On a continuum, where only minimal adjustments were made, one of the adjustments could represent the need for life insurers to adjust their reserves but only where needed to meet asset adequacy testing.
- Regulatory rules and additional conservatism currently contained within U.S. Insurance Regulatory Accounting are significantly reduced. Consideration is given to requiring disclosure of these differences in some type of new financial reporting schedule.
- U.S. insurance regulators will be trained on IFRS or U.S. GAAP as that will become the primary input for their accounting model, and thus will be able to ask the Federal Reserve and/or international insurance regulators the appropriate questions dealing with the entities they regulate which impact insurers. They will also be able to respond to questions that other regulators have regarding the accounting of U.S. insurers' position within an IFRS or U.S. GAAP financial statement.
- U.S. insurance regulators do not require control over the primary input for their accounting model, but anticipate utilizing limited statutory adjustments, financial reporting identifying differences, and risk-based capital to capture issues not addressed by IFRS or U.S. GAAP.
- This option could involve a public blank based upon IFRS, with statutory adjustments being reported in a confidential, regulator only filing (or even as additional tables within RBC that feed the statutory inputs for RBC), which could potentially minimize issues regarding sunshine laws and the need for additional/substantially modified state statutes and regulations (e.g., the regulator only capital and surplus would still be utilized for extraordinary dividend considerations and other regulatory triggers).
- Statutory adjustments are limited to only what is necessary, thus eliminating the need for a recodification and the use of a consultant. Existing NAIC staff is maintained in order to develop and present training on IFRS as well as answering regulator questions on IFRS and statutory adjustments.
- The basis of accounting could continue to be the state prescribed and permitted basis as defined in state law, with continued requirements to follow the NAIC accounting manual. Differences between the NAIC basis (e.g., IFRS or U.S. GAAP with APP adjustments) and state basis of accounting will continue to be disclosed.
- Consistent with IASB suggestions on IFRS for small and medium companies, insurers are required to follow IFRS/U.S. GAAP since the complexity included in such accounting is mostly focused on those areas where insurers pose more risk than other nonpublic companies (e.g., financial instruments and insurance contracts).
- U.S. insurance regulators will continue to require the existing transparency that US regulatory statements and disclosures provide since US GAAP, IFRS, and Solvency II do not provide this transparency.
- NAIC model laws are reviewed to consider if they require updating for issues that no longer exist (e.g., nonadmitted assets if such a concept goes away). However, capital requirements may need to be updated regardless given other projects occurring within the Solvency Modernization Initiative.
- Taxation issues of insurers may need to be discussed.

IFRS for public companies IFRS/GAAP with statutory adjustments for nonpublic companies: IFRS for public companies and some other basis for nonpublic (private insurers). This contemplates abandonment of the current SAP model and utilizing the public IFRS/GAAP accounting model for public companies; and for nonpublic companies, IFRS/GAAP would be used but with limited statutory adjustments for only those areas where such standards are overly complex. This could be done either through a shortened NAIC accounting model, risk-based capital, and/or model laws.

Under this option the following is presumed to represent the regulatory views of specific issues:

- The benefits of a dual regulatory accounting system are viewed as outweighing the detriments.
- The conservatism and regulatory rules for public companies is moved to risk-based capital. For nonpublic companies, regulatory rules and additional conservatism are significantly reduced. Consideration is given to require disclosure of these differences in some type of new financial reporting schedule. Depending upon the materiality of the differences, consideration of a regulator only filing (including additional schedules in RBC) may need to occur.
- U.S. insurance regulators will be trained on IFRS or U.S. GAAP as that will become the basis of accounting for public companies and the primary input for non public companies, and thus will be able to ask the federal reserve and/or international insurance regulators the appropriate questions dealing with the entities they regulate which impact insurers. They will also be able to respond to questions that other regulators have regarding the accounting of a U.S. insurer's position within IFRS or U.S. GAAP financial statements.
- U.S. insurance regulators do not require control over the primary input for their accounting model, but anticipate utilizing limited statutory adjustments, financial reporting to identify differences, and risk-based capital to capture issues not addressed by IFRS or U.S. GAAP.
- Statutory adjustments are limited to only what is necessary, thus eliminating the need for a recodification and the use of a consultant. Existing NAIC staff is maintained in order to develop and present training on IFRS as well as answering regulator questions on IFRS and the limited statutory adjustments for nonpublic companies.
- The basis of accounting could continue to be the state prescribed and permitted basis as defined in state law, with continued requirements to follow the NAIC accounting manual. The NAIC accounting manual could require IFRS or U.S. GAAP to be followed by public companies and could specify the limited adjustments necessary for nonpublic companies. Differences between the NAIC basis (e.g. IFRS or U.S. GAAP with APP adjustments) and state basis of accounting will continue to be disclosed.
- Consistent with IASB suggestions on IFRS for small and medium companies, insurers are required to follow IFRS/U.S. GAAP for financial instruments and insurance contracts but exceptions are allowed for nonpublic companies on other items that are less material but complex (e.g., leases).
- U.S. insurance regulators will continue to require the existing transparency that US regulatory statements and disclosures provide since US GAAP, IFRS, and Solvency II do not provide this transparency.
- NAIC model laws are reviewed to consider if they require updating for issues that no longer exist (e.g., nonadmitted assets if such a concept goes away). However, capital requirements may need to be updated regardless given other projects occurring within the Solvency Modernization Initiative.
- Taxation issues of insurers may need to be discussed.

Z) IFRS without adjustments: Abandon SAP and utilize the public IFRS/GAAP accounting model, with no statutory adjustments, for regulatory accounting as well.

Under this option the following is presumed to represent the regulatory views of specific issues:

- The conservatism and regulatory rules for all insurers is moved to risk-based capital. Consideration is given to require disclosure or separate regulatory filings for those things that cannot be moved into risk-based capital.
- The statutory financial statement continues to serve the needs of regulators and all other users.
- U.S. insurance regulators will be trained on IFRS or U.S. GAAP as that will become the basis of accounting for all companies. U.S. insurance regulators will be able to ask the Federal Reserve and/or international insurance regulators the appropriate questions dealing with the entities they regulate which impact insurers. They will also be able to respond to questions that other regulators have regarding the accounting of U.S. insurer's position within IFRS or U.S. GAAP financial statement.
- U.S. insurance regulators do not require control over the primary input for their accounting model, but anticipate utilizing limited statutory adjustments, financial reporting identifying differences, and risk-based capital to capture issues not addressed by IFRS or U.S. GAAP.
- IFRS or U.S. GAAP is required for all companies, thus eliminating the need for a recodification and the use of a consultant. Existing NAIC staff is maintained in order to develop and present training on IFRS as well as answering regulator questions on IFRS.
- The basis of accounting may either become IFRS or U.S. GAAP, thus eliminating state prescribed and permitted basis, or continue as such with removal of reference to the NAIC accounting manual and reference to IFRS or U.S. GAAP instead. Differences between IFRS or U.S. GAAP and state basis of accounting will continue to be disclosed.
- Consistent with IASB suggestions on IFRS for small and medium companies, insurers are required to follow IFRS/U.S. GAAP, including some of the more complex accounting required under such.
- U.S. insurance regulators will continue to require the existing transparency that US regulatory statements and disclosures provide since US GAAP, IFRS, and Solvency II do not provide this transparency.
- NAIC model laws are reviewed to consider if they require updating for issues that no longer exist (e.g. nonadmitted assets). However, capital requirements may need to be updated regardless given other projects occurring within the Solvency Modernization Initiative.
- Taxation issues of insurers may be an issue that needs to be discussed.

3. *Should regulatory financial statements be utilized for public purposes or should a separate public financial filing be required?*

The choices for this question are also related to the answers to the previous questions. For example, if the NAIC decides to adopt the IFRS/GAAP converged accounting system with no statutory modifications, the answer to this question would be the current status quo where the regulatory and other users utilize the statutory blank.

Continuum: Possible scenarios on the continuum are:

Current process: Maintain the current status, using the NAIC blank for both regulatory reporting and public reporting purposes.

Middle of the continuum: Require the NAIC blank to be filed for public reporting purposes and include specific statutory basis exhibits and schedules in the confidential RBC filing (these would be used for RBC calculation as well as the statutory surplus referenced in existing regulatory triggers, etc.).

Most changes: Establish a separate public reporting financial statement and utilize an entirely different confidential financial statement for regulators only.

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