

# **CAS Exam 6-United States Study Kit**

## ***Accounting Practices and Procedures Manual*** **Preamble**

National Association of Insurance Commissioners

### **Source:**

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# Statutory Accounting Principles

## Preamble

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Section VII Interpreted by: INT 00-20

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### I. History of Accounting Practices and Procedures Promulgated by the NAIC

#### A. Background

1. The NAIC, through its committees and working groups, facilitated many projects of importance to the insurance regulators, industry, and users of statutory financial information. That ~~was~~ evidenced by the mission statement and charges of the NAIC Accounting Practices and Procedures Task Force of the Financial Condition (E) Committee (Accounting Practices and Procedures (E) Task Force).

2. The mission of the Accounting Practices and Procedures (E) Task Force ~~was~~ to identify, investigate and develop solutions to accounting problems with the ultimate goal of guiding insurers in properly accounting for various aspects of their operations and to modify the NAIC *Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, for Life, Accident and Health Insurance Companies, and for Health Maintenance Organizations* (Accounting Practices and Procedures manuals) to reflect changes necessitated by task force action and to study innovative insurer accounting practices which affect the ability of regulators to determine the true financial condition of insurers.

3. To carry out the mission, the Accounting Practices and Procedures (E) Task Force ~~was~~ charged with carrying out the following initiatives:

- Provide authoritative guidance to insurance regulators on current statutory accounting issues.
- Continue evaluation of statutory accounting principles for purposes of development, expansion and codification.
- Extend evaluation of statutory accounting principles to address areas specific to health entities.
- The Codification of Statutory Accounting Principles (E) Working Group (Statutory Accounting Principles (E) Working Group as of January 1, 2000) will maintain codified statutory accounting principles by providing periodic updates to the guidance which address new statutory issues and new generally accepted accounting principles (GAAP) pronouncements as they develop.

4. ~~This~~The comprehensive guide to statutory accounting principles, composed of the Preamble, the Statements of Statutory Accounting Principles (SSAPs), and the Appendices, ~~was~~ intended to respond to the initiatives noted above. The guide and interpretations of the Emerging Accounting Issues (E) Working Group ~~was~~shall be referred to as the *Accounting Practices and Procedures Manual* - version effective January 1, 2001 (during the transition period until the 1998 version ~~is~~was no longer maintained and updated by the NAIC). The 1998 version of the *Accounting Practices and Procedures Manual* ~~was~~will be maintained and published until December 31, 2000. However, ~~the~~this Manual ~~was~~ not intended to preempt states' legislative and regulatory authority. It ~~was~~ intended to establish a comprehensive basis

## Preamble

of accounting recognized and adhered to if not in conflict with state statutes and/or regulations, or when the state statutes and/or regulations are silent.

~~5. The principles established by this Manual are effective January 1, 2001. Accounting changes adopted to conform to the provisions of these statements shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle; however, specific effective dates, and transition or grandfathering rules, if any, are contained in each SSAP.~~

## ~~H. Background~~

### ~~A. An Accounting Environment for Insurance Companies~~

~~6. Accounting is the process of accumulating and reporting financial information about an economic unit or group of units. Relative to commercial enterprises, the users of accounting information include management, investors, potential investors, lenders, investment analysts, regulators, and customers. Although customers of most commercial enterprises have no direct financial interest therein and generally are only concerned with the price to be paid for the product or service purchased, they may use accounting information to make choices as to the entity with which they engage in a business transaction. This is particularly relevant to purchases of insurance products inasmuch as insurance contracts involve a promise to pay which may extend years into the future. Insurance products may provide benefits well in excess of the purchase price or premium. The benefits ultimately received are almost always greater than the price (premium) paid and can only be estimated at the time the product (policy) is purchased.~~

~~7. Insurance is regulated on a state by state basis in the United States. Each state has its own regulatory framework generally led by an insurance commissioner. Insurance commissioners are charged with overseeing the financial condition of insurance companies doing business in their jurisdictions and they require meaningful financial, statistical, and operating information about the companies. This financial oversight is designed to help ensure that policyholders and claimants receive the requisite benefits from the policies sold, often times such products having been sold years or decades prior to when the benefits are due. Frequently, this regulatory perspective differs markedly from the perspectives of other users of insurers' accounting information. In recognition of these special concerns and responsibilities, statutory accounting principles have been established by statute, regulation, and practice.~~

### ~~B. Statutory Accounting Principles (SAP)~~

~~8. In simplest terms, SAP has been those accounting principles or practices prescribed or permitted by an insurer's domiciliary state. Statutory accounting practices have been interspersed in the insurance laws, regulations, and administrative rulings of each state, the Accounting Practices and Procedures manuals, the Annual Statement Instructions, the NAIC Financial Condition Examiners Handbook, the Purposes and Procedures Manual of the NAIC Investment Analysis Office, and NAIC committee, task force, and working group minutes. In addition, there are many statutory practices widely accepted by both insurers and regulators which have never been codified.~~

~~9. SAP is conservative in some respects but not unreasonably conservative over the span of economic cycles, or in recognition of the primary statutory responsibility to regulate for financial solvency. SAP attempts to determine at the financial statement date an insurer's ability to satisfy its obligations to its policyholders and creditors.~~

### ~~C. Comparison Of GAAP And SAP~~

~~10. The objectives of GAAP reporting differ from the objectives of SAP. GAAP is designed to meet the varying needs of the different users of financial statements. SAP is designed to address the concerns of regulators, who are the primary users of statutory financial statements. As a result, GAAP stresses measurement of emerging earnings of a business from period to period, (i.e., matching revenue to~~

~~expense), while SAP stresses measurement of ability to pay claims in the future. This difference is illustrated by the fact that statutory policy reserves are intentionally established on a conservative basis emphasizing the long term nature of the liabilities. Under GAAP, the experience expected by each company, with provision for the risk of adverse deviation, is used to determine the reserves it will establish for its policies. GAAP reserves may be more or less than the statutory policy reserves.~~

~~11. Some other differences between SAP and GAAP have included:~~

- ~~• GAAP has recognized certain assets which, for statutory purposes, have been either nonadmitted or immediately expensed. Policy acquisition costs are expensed as incurred under SAP since the funds so expended are no longer available to pay future liabilities. Insurance company financial statements prepared in accordance with GAAP defer costs incurred in the acquisition of new business and amortize them over the premium recognition period.~~
- ~~• Deferred income taxes have, historically, not been recognized under SAP.~~
- ~~• The methods of accounting for certain aspects of reinsurance under GAAP may have varied from SAP, e.g., credit for reinsurance in unauthorized companies.~~

#### **DB. Purpose of Codification**

~~125.~~ The purpose of the codification of statutory accounting principles was to produce a comprehensive guide to SAP for use by insurance departments, insurers, and auditors. Statutory accounting principles, as they existed prior to codification did not always provide a consistent and comprehensive basis of accounting and reporting. The prescribed or permitted statutory accounting model resulted in practices that could have varied from state to state. Insurance companies were sometimes uncertain about what rules to follow and regulators were sometimes unfamiliar with the accounting rules followed by insurers in other states. As a result, insurers' financial statements were not always prepared on a comparable basis.

~~136.~~ ~~In engaging this~~ As part of the codification project, it was necessary to revisit principles that had been developed over a long period of time and to consider ~~recently~~ recently-identified accounting issues not ~~currently~~ addressed by SAP. In many cases, previously available choices of accounting methods were eliminated. Also considered was the current state of the regulatory environment and the tools ~~more~~ more ~~recently~~ developed, such as risk-based capital (RBC). ~~These new~~ Those financial analytical tools allowed for a reconsideration of the level of conservatism necessary to achieve regulatory objectives.

~~147.~~ The Codification project ~~will~~ resulted in more complete disclosures and more comparable financial statements, ~~which will make~~ making the insurance departments' analysis techniques more meaningful and effective. The project ~~will~~ provided examiners and analysts with uniform accounting rules against which companies' financial statements ~~can~~ could be evaluated. RBC, an important tool used by the states to measure solvency of insurers, ~~will~~ be reported more consistently with the benefit of codification.

#### **EC. History of Codification**

~~158.~~ In 1989, the NAIC adopted a Solvency Agenda designed to enhance the ability of state regulators to protect insurance consumers from the financial trauma of insurer insolvency. In recognition of the fact that enhancement of solvency regulation is an ongoing process, the agenda was updated in 1991. Since 1991, most major initiatives of the 1991 Solvency Agenda have been accomplished. They include: 1) revision of the NAIC *Financial Condition Examiners Handbook*, 2) development of a risk-based capital approach to define required levels of capital and surplus, 3) development of a model law on authorized insurer investments, 4) creation of a centralized financial analysis unit to perform

comprehensive analysis of insurance companies who may be troubled, 5) development of computerized analytical routines for use by state insurance departments, and 6) creation of an NAIC education fund.

169. The codification project ~~is also~~ was a direct result of the 1991 Solvency Agenda. The goal was "evaluation of existing statutory accounting principles as presently outlined in the *Accounting Practices and Procedures Manual* for purposes of further development, expansion, and codification."

1710. Beginning in 1994, the NAIC's efforts to codify SAP were strengthened and reorganized recognizing the need for expediency. There was both a commitment of substantial financial resources as well as the selection of a team of dedicated regulators who were willing to commit the time and effort necessary to accomplish one of the most significant undertakings that has been faced by the NAIC.

1811. Recognition of this effort was given by the AICPA when in 1995 they issued *Statement of Position 95-5—Auditor's Report on Statutory Financial Statements of Insurance Enterprises (SOP 95-5)* so that an auditor's opinion on a "prescribed or permitted" basis could continue until codification was completed. SOP 95-5 states "The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance enterprises." At that time, it was believed that once Codification was effective, in order for certified public accountants (CPAs) to issue opinions on statutory statements, SAP had to be considered an "Other Comprehensive Basis of Accounting" (OCBOA) by the American Institute of Certified Public Accountants (AICPA).

1912. Codification is not intended to preempt state legislative and regulatory authority. While Codification is expected to be the foundation of a state's statutory accounting practices, it may be subject to modification by practices prescribed or permitted by a state's insurance commissioner. Statutory financial statements will continue to be prepared on the basis of accounting practices prescribed or permitted by the states. As a result, in 1998 the AICPA's Insurance Companies Committee determined that it will not be necessary for the Auditing Standards Board to grant the Codification status as an OCBOA since it will not be the sole basis for preparing statutory financial statements. Further, auditors will be permitted to continue to provide audit opinions on practices prescribed or permitted by the insurance department of the state of domicile.

#### D. Result of Codification Project

13. The conceptual framework used in developing and maintaining statutory accounting principles for insurance companies was summarized in the Statutory Accounting Principles Statement of Concepts (Section IV of Preamble). The application of the concepts of conservatism, consistency and recognition assured that guidance developed and codified as part of this project was consistent with the underlying objectives of statutory accounting.

14. The inaugural NAIC Practices and Procedures Manual was developed using the body of statutory accounting principles as prescribed in the statutory hierarchy of accounting guidance (Section V of Preamble), which is incorporated into the Statement of Concepts. The hierarchy provides the guidance for judging the presentation of statutory financial statements in conformance with statutory accounting principles.

15. The principles established through codification were effective January 1, 2001. Accounting changes adopted to conform to the provisions of these statements were reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle; however, specific effective dates, and transition or grandfathering rules, if any, are contained in each SSAP. Subsequent revisions or the adoption of new SSAP's subsequent to original codification shall follow the adoption and transition guidance detailed within each individual SSAP.

## II. Accounting for Insurance Companies

### A. Environment

16. Accounting is the process of accumulating and reporting financial information about an economic unit or group of units. Relative to commercial enterprises, the users of accounting information include management, investors, potential investors, lenders, investment analysts, regulators and customers. Although customers of most commercial enterprises have no direct financial interest therein and generally are only concerned with the price to be paid for the product or service purchased, they may use accounting information to make choices as to the entity with which they engage in a business transaction. This is particularly relevant to purchases of insurance products as insurance contracts involve a promise to pay which may extend years into the future. Insurance products may provide benefits well in excess of the purchase price or premium. The benefits ultimately received are almost always greater than the price (premium) paid and can only be estimated at the time the product (policy) is purchased.

17. Insurance is regulated on a state-by-state basis in the United States. Each state has its own regulatory framework generally led by an insurance commissioner. Insurance commissioners are charged with overseeing the financial condition of insurance companies doing business in their jurisdictions and they require meaningful financial, statistical, and operating information about the companies. This financial oversight is designed to help ensure that policyholders and claimants receive the requisite benefits from the policies sold, often times such products having been sold years or decades prior to when the benefits are due. Frequently, this regulatory perspective differs markedly from the perspectives of other users of insurers' accounting information. In recognition of these special concerns and responsibilities, statutory accounting principles have been established by statute, regulation and practice.

### B. Statutory Accounting Principles (SAP)

18. In simplest terms, SAP has been those accounting principles or practices prescribed or permitted by an insurer's domiciliary state. Statutory accounting practices have been interspersed in the insurance laws, regulations, and administrative rulings of each state, the accounting practices and procedures manuals, the annual statement instructions, the NAIC *Financial Condition Examiners Handbook*, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and NAIC committee, task force, and working group minutes. In addition, there are many statutory practices widely accepted by both insurers and regulators which have never been codified.

19. SAP is conservative in some respects but not unreasonably conservative over the span of economic cycles, or in recognition of the primary statutory responsibility to regulate for financial solvency. SAP attempts to determine at the financial statement date an insurer's ability to satisfy its obligations to its policyholders and creditors.

### C. Comparison of Generally Accepted Accounting Principles (GAAP) and SAP

20. The objectives of GAAP reporting differ from the objectives of SAP. GAAP is designed to meet the varying needs of the different users of financial statements. SAP is designed to address the concerns of regulators, who are the primary users of statutory financial statements. As a result, GAAP stresses measurement of emerging earnings of a business from period to period, (i.e., matching revenue to expense), while SAP stresses measurement of ability to pay claims in the future. This difference is illustrated by the fact that statutory policy reserves are intentionally established on a conservative basis emphasizing the long-term nature of the liabilities. Under GAAP, the experience expected by each company, with provision for the risk of adverse deviation, is used to determine the reserves it will establish for its policies. GAAP reserves may be more or less than the statutory policy reserves. In addition, another primary difference is that GAAP has recognized certain assets which, for statutory purposes, have been either nonadmitted or immediately expensed. For example, policy acquisition costs are expensed as incurred under SAP since the funds so expended are no longer available to pay future

liabilities. Insurance company financial statements prepared in accordance with GAAP defer costs incurred in the acquisition of new business and amortize them over the premium recognition period.

### III. Development of Ongoing Accounting Practices and Procedures

21. The mission of the Accounting Practices and Procedures (E) Task Force is to identify, investigate and develop solutions to accounting problems with the ultimate goal of guiding insurers in properly accounting for various aspects of their operations, to modify the NAIC *Accounting Practices and Procedures Manual* to reflect changes necessitated by Task Force action, and to study innovative insurer accounting practices which affect the ability of regulators to determine the true financial condition of insurers.

22. The role of the Accounting Practices and Procedures (E) Task Force is further defined in the Policy Statement of this Manual.

23. The Accounting Practices and Procedures (E) Task Force will accomplish its mission through charges assigned to the following working groups:

- Statutory Accounting Principles (E) Working Group: Responsible for developing and adopting substantive and nonsubstantive revisions to the Statements of Statutory Accounting Principles (SSAPs). Statutory accounting principles provide the basis for insurers to prepare financial statements for financial regulation purposes, and SSAPs are considered level 1 (highest authority) in the statutory accounting hierarchy. Refer to the Statutory Accounting Principles (E) Working Group Web page ([http://www.naic.org/committees\\_e\\_app\\_sapwg.htm](http://www.naic.org/committees_e_app_sapwg.htm)) for specific information and charges.
- Blanks (E) Working Group: Considers improvements and revisions to various annual/quarterly statement blanks to conform to changes made in other areas of the NAIC to promote uniformity in reporting of financial information by insurers and develop reporting formats for other entities subject to the jurisdiction of state insurance departments. Refer to the Blanks (E) Working Group webpage ([http://www.naic.org/committees\\_e\\_app\\_blanks.htm](http://www.naic.org/committees_e_app_blanks.htm)) for specific information and charges.

24. This comprehensive guide to statutory accounting principles, composed of the Preamble, the Statements of Statutory Accounting Principles (SSAPs) and the Appendices, is intended to respond to the mission of the Accounting Practices and Procedures (E) Task Force and the charges of its affiliated working groups as noted above. The Manual is not intended to preempt states' legislative and regulatory authority. It is intended to establish a comprehensive basis of accounting recognized and adhered to if not in conflict with state statutes and/or regulations, or when the state statutes and/or regulations are silent.

#### F. Scope of Project

~~20. The conceptual framework used in developing and maintaining statutory accounting principles for insurance companies is summarized in the Statutory Accounting Principles Statement of Concepts. The application of the concepts of conservatism, consistency and recognition assure that guidance developed and codified as part of this project is consistent with the underlying objectives of statutory accounting.~~

~~21. This Guide has been developed using the body of statutory accounting principles as prescribed in the statutory hierarchy of accounting guidance, which is incorporated into the Statement of Concepts. This hierarchy provides the guidance for judging the presentation of statutory financial statements in conformance with statutory accounting principles.~~

September 20, 1994

## **III. Statutory Accounting Principles Statement of Concepts**

### **A. ~~Purpose of Statement of Concepts for Statutory Accounting Principles~~**

**2225.** This document states the fundamental concepts on which statutory financial accounting and reporting standards are based. These concepts provide a framework to guide the National Association of Insurance Commissioners (NAIC) in the continued development and maintenance of statutory accounting principles (“SAP” or “statutory basis”) and, as such, these concepts and principles constitute an accounting basis for the preparation and issuance of statutory financial statements by insurance companies in the absence of state statutes and/or regulations.<sup>1</sup>

**2326.** The NAIC and state insurance departments are primarily concerned with statutory accounting principles that differ from GAAP reflective of the varying objectives of regulation. Recodification of areas where SAP and GAAP are parallel is an inefficient use of limited resources.

**2427.** SAP utilizes the framework established by GAAP.<sup>2</sup> This document integrates that framework with objectives exclusive to statutory accounting. The NAIC’s guidance on SAP is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting outlined herein. Those GAAP pronouncements that are not applicable to insurance companies will not be adopted by the NAIC. For those principles that do not differ from GAAP, the NAIC ~~must~~ may specifically adopt those GAAP Pronouncements to be included in statutory accounting. GAAP Pronouncements do not become part of SAP until and unless adopted by the NAIC.

**2528.** The body of statutory accounting principles is prescribed in the statutory hierarchy of accounting guidance. This hierarchy provides the framework for judging the presentation of statutory financial statements in conformance with statutory accounting principles.

**2629.** Statutory requirements vary from state to state. While it is desirable to minimize these variations, to the extent that they exist it is the objective of NAIC statutory accounting principles to provide the standard against which the exceptions will be measured and disclosed if material.

### **B. Objectives of Statutory Financial Reporting**

**2730.** The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

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<sup>1</sup> As stated in the NAIC’s constitution, the NAIC is an association of chief insurance regulatory officials of the 50 states, the District of Columbia, American Samoa, Guam, Puerto Rico, and the Virgin Islands whose objective is to serve the public by assisting several state insurance supervisory officials, individually and collectively, in achieving the following fundamental insurance regulatory objectives:

1. Maintenance and improvement of state regulation of insurance in a responsive and efficient manner;
2. Reliability of the insurance institution as to financial solidity and guaranty against loss;
3. Fair, just, and equitable treatment of policyholders and claimants.

<sup>2</sup> The GAAP framework applicable to insurance accounting is set forth in *Statements of Financial Accounting Concepts One, Two, Five, and Six*. These documents, promulgated by the Financial Accounting Standards Board, set forth the objectives and concepts which are used in developing accounting and reporting standards.



2831. Statutory reporting applies to all insurers authorized to do business in the United States and its territories, and requires sufficient information to meet the statutory objectives. However, statutory reporting as contained in this guide is not intended to preempt state legislative and regulatory authority. The SAP financial statements include the balance sheet and related summary of operations, changes in capital and surplus, and cash flow statements. Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity's short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g., notes to financial statements, management's discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.

### **C. Concepts**

#### **Conservatism**

2932. Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

3033. Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.

#### **Consistency**

3134. The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

#### **Recognition**

3235. The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

3336. The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

## Preamble

3437. Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

3538. Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

3639. SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process (e.g., changes in nonadmitted assets).

### D. Conclusion

3740. This document states the fundamental concepts for financial statements presented on the basis of SAP. These concepts summarize the conceptual framework that the NAIC uses in developing and maintaining statutory accounting principles for insurance companies. These concepts will also assure that guidance will be provided consistently with the underlying objectives of statutory accounting and will aid in the review of emerging accounting issues.

3841. The multitude of unique circumstances and individual transactions makes it virtually impossible for any codification of accounting principles to be totally comprehensive. Application of SAP, either contained in the SSAPs or defined as GAAP and adopted by the NAIC, to unique circumstances or individual transactions should be consistent with the concepts of conservatism, consistency, and recognition.

## IV. Statutory Hierarchy

The following Hierarchy is not intended to preempt state legislative and regulatory authority.

### Level 1:

- SSAPs, including U.S. GAAP reference material to the extent adopted by the NAIC from the FASB Accounting Standards Codification<sup>3</sup> (FASB Codification or GAAP guidance)<sup>4-5</sup>.

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<sup>3</sup> Effective September 15, 2009, the FASB Codification is the source of authoritative U.S. generally accepted accounting principles. As of that date, the FASB Codification superseded all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the FASB Codification is nonauthoritative. As of September 15, 2009, AICPA Statements of Position are no longer reviewed as part of the statutory maintenance process as they are no longer considered authoritative GAAP literature. If the AICPA were to address an issue that affects the FASB Codification, an accounting standard update (ASU) would be issued and reviewed for applicability to statutory accounting.

<sup>4</sup> ~~FAS 133 Implementation Issues are excluded from the NAIC hierarchy and statutory accounting standard review process unless considered significant and relevant to statutory accounting and specifically requested for review as part of the maintenance process, or in accordance with future projects in which review of a specific FAS 133 Implementation Issue would be considered beneficial. (These items are excluded from the maintenance process as SSAP No. 86 only adopts the framework of the guidance included in FAS 133.)~~

<sup>5</sup> ~~FASB Staff Positions (FSPs) adopted after May 9, 2008, are reviewed as part of the statutory accounting maintenance review process. FSPs adopted prior to May 9, 2008, were reviewed as part of the maintenance process if considered to be 'Board directed'. (Board directed FSPs were issued to provide narrow and limited revisions to the FASB statements or FASB interpretations formerly provided in FASB Technical Bulletins.) FSPs that were not considered 'Board directed' were considered to provide application guidance similar to that found in FASB Staff Implementation Guides and Staff Announcements and were not reviewed as part of the statutory accounting maintenance review process.~~

## Preamble

### Level 2:

- Consensus positions of the Emerging Accounting Issues (E) Working Group as adopted by the NAIC (INTs adopted before 2016)
- Interpretations of existing SSAPs as adopted by the Statutory Accounting Principles (E) Working Group (INTs adopted in 2016 or beyond)

### Level 3:

- NAIC Annual Statement Instructions
- Purposes and Procedures Manual of the NAIC Investment Analysis Office

### Level 4:

- Statutory Accounting Principles Preamble and Statement of Concepts<sup>6</sup>

### Level 5:

- Sources of nonauthoritative GAAP accounting guidance and literature, including: (a) practices that are widely recognized and prevalent either generally or in the industry, (b) FASB Concept Statements, (c) AICPA Issue Papers guidance not included in FASB Codification, (d) International Financial Reporting Standards, (e) Pronouncements of professional associations or regulatory agencies, (f) Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids, and (g) Accounting textbooks, handbooks and articles.

**3942.** If the accounting treatment of a transaction or event is not specified by the SSAPs, preparers, regulators and auditors of statutory financial statements should consider whether the accounting treatment is specified by another source of established statutory accounting principles. If an established statutory accounting principle from one or more sources in Level 2 or 3 is relevant to the circumstances, the preparer, regulator or auditor should apply such principle. If there is a conflict between statutory accounting principles from one or more sources in Level 2 or 3, the preparer, regulator or auditor should follow the treatment specified by the source in the higher level—that is, follow Level 2 treatment over Level 3. Revisions to guidance in accordance with additions or revisions to the NAIC statutory hierarchy should be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

**4043.** Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established statutory accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting a statutory accounting principle that appears appropriate when applied in a manner similar to the application of an established statutory principle to an analogous transaction or event. In the absence of a SSAP or another source of established statutory accounting principles, the preparer, regulator or auditor of statutory financial statements may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes the Statutory Accounting Principles Statement of Concepts and GAAP reference material and accounting literature identified in Level 5. The appropriateness of other accounting literature depends on its relevance to the

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<sup>6</sup> The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concepts Statements One, Two, Five and Six to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy the FASB Concepts Statements shall be included in Level 5 and only those concepts unique to statutory accounting as stated in the statement are included in Level 4.

## Preamble

particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, the Statutory Accounting Principles Statement of Concepts would be more authoritative than any other sources of accounting literature. Similarly, FASB Concepts Statements would normally be more influential than other sources of nonauthoritative GAAP pronouncements.

## VI. Statements of Statutory Accounting Principles

**4144.** This Manual consists primarily of Statements of Statutory Accounting Principles (SSAPs). SSAPs are the primary Accounting Practices and Procedures promulgated by the NAIC. These statements are the result of issue papers that have been exposed for public comment and finalized. Finalized issue papers are in Appendix E. While it is not intended that there be any significant differences between an underlying issue paper and the resultant SSAP, if differences exist, the SSAP prevails and shall be considered definitive.

**4245.** SSAPs designated as Common Area apply to all insurers. Although the nomenclature or terms provided in the prescribed annual statement forms may vary among different types of insurers, only one set of nomenclature or terms may have been used in the SSAP. For example, the Statement of Income found in the Property and Casualty Annual Statement shall be considered as synonymous with the Summary of Operations found in the Life and Health Annual Statement.

**4346.** Once promulgated, statements will only be amended or superseded through the issuance of new SSAP pronouncements. If it is necessary to substantially modify or augment the guidance in a SSAP, a new statement will be promulgated and/or the statement will be reissued with “revised” in the title. Non-substantial changes will be included in the existing statement with changes tracked (i.e., new text will be underlined and deleted text as strikethrough) in the next printing of the Manual. Then no changes will be shown after the initial year. A useful tool for tracking of the relationships between statements is contained in the “Status” section of each statement which includes sections labeled “Affects” and “Affected By.” As SSAPs are issued in the future that modify or augment the guidance previously provided, these sections will identify the relationships between statements.

## VII. Materiality

**4447.** Those who make accounting decisions and those who make judgments as regulators and auditors continually confront the need to make judgments about materiality. Materiality judgments are primarily quantitative in nature. They pose the question: Is this item large enough for users of the information to be influenced by it? However, the answer to that question will usually be affected by the nature of the item; items too small to be thought material if they result from routine transactions may be considered material if they arise in abnormal circumstances.

**4548.** Materiality judgments are concerned with screens or thresholds. Is an item, an error, or an omission large enough, considering its nature and the attendant circumstances, to pass over the threshold that separates material from immaterial items? The more important a judgment item is, the finer the screen should be that will be used to determine whether it is material. For example:

- Circumstances where an accounting adjustment puts an insurer in danger of being in breach of a covenant or regulatory requirement may justify a lower materiality threshold than if its position were stronger. For example, an error resulting from an insurer incorrectly reporting certain nonadmitted assets as admitted assets might be considered material if the classification of those assets as nonadmitted would cause the insurer to trigger an event under the Risk-Based Capital requirements.
- A failure to disclose separately a nonrecurrent item of revenue may be material at a lower threshold than would otherwise be the case if the revenue turns a loss into a profit or reverses the trend of earnings from a downward to an upward trend.

## Preamble

- A miscategorization of assets or liabilities that would not be material in amount to the basic financial statements, but would cause the insurer to trigger an event under the Risk-Based Capital requirements, might be material.
- Amounts too small to warrant disclosure or correction in normal circumstances may be considered material if they arise from abnormal or unusual transactions or events.

4649. Almost always, the relative rather than the absolute size of a judgment item determines whether it should be considered material in a given situation. Losses from bad debts that could be shrugged off as routine by a large insurer may threaten the continued existence of a small one. An error in reserve valuation may be material in a small insurer for which it cut earnings in half but immaterial in an insurer for which it might make a barely perceptible ripple in the earnings.

4750. Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second.

4851. Individual judgments are required to assess materiality. The essence of the materiality concept is clear. The omission or misstatement of an item in a statutory financial statement is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the statutory financial statement would have been changed or influenced by the inclusion or correction of the item.

4952. The provisions of this Manual need not be applied to immaterial items. INT 00-20: Application of SEC SAB No. 99, Materiality to the Preamble of the AP&P Manual provides further information on the application of the concept of materiality. <sup>(INT 00-20)</sup>

## VIII. Relationship to GAAP

5053. As expressed in the Statement of Concepts, SAP utilizes the framework established by GAAP. This Manual integrates that framework with objectives exclusive to statutory accounting. The NAIC's guidance on SAP is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting outlined herein. GAAP guidance that is not applicable to insurance companies will not be adopted by the NAIC. For those principles that do not differ from GAAP, the NAIC may specifically adopt GAAP guidance to be included in statutory accounting. Elements of the FASB Codification do not become part of SAP until and unless adopted by the NAIC. Future SAP pronouncements will specifically identify any element of the FASB Codification that is to be included in SAP whether in whole, in part, or with modification as well as any rejected GAAP guidance. GAAP guidance which SAP has not yet addressed shall not be considered as providing authoritative statutory guidance.

## VIIIIX. Relationship to Developments within NAIC

5154. Various NAIC committees and their working groups will be involved in issues, at any point in time, ~~that~~ which could impact accounting guidance. Recommendations that affect accounting guidance must be referred to the Accounting Practices and Procedures (E) Task Force which has the responsibility for the maintenance of this Manual for determination of appropriate inclusion in SAP.

5255. There are instances where the Codification of Statutory Accounting Principles (E) Working Group (Statutory Accounting Principles (E) Working Group as of January 1, 2000) has established an accounting principle in a SSAP but deferred maintenance and update of the detailed guidance to other NAIC task forces and their working groups. Those instances are specifically set forth in the individual

## Preamble

SSAPs and include specific guidance for calculation of the Interest Maintenance Reserve (IMR), the Asset Valuation Reserve (AVR), the provision for overdue reinsurance, and periodic update to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*.

§356. Changes to statutory accounting principles are not authoritative until approved by the general membership of the NAIC.

### **IX. Permitted Accounting Practices**

§457. In instances where the domiciliary state regulator is considering approval of a request for an accounting practice that departs from the NAIC *Accounting Practices and Procedures Manual* (Manual) and state prescribed accounting practices, the domiciliary regulator must provide Notice as defined in paragraphs §5-5758-60.

§558. No domiciliary state regulatory authority shall grant an approval to use an accounting practice, as described in paragraph §457, unless it provides Notice at least 5 days in advance of such approval.

§659. This Notice must disclose the following information regarding the requested accounting practice request to all other states in which the insurer is licensed prior to the financial statement filing date:

- a. The nature and a clear description of the permitted accounting practice request;
- b. The quantitative effect of the permitted accounting practice request with all other approved permitted accounting practices currently in effect as disclosed in Appendix A-205: Illustrative Disclosure of Differences Between NAIC Statutory Accounting Practices and Procedures and Accounting Practices Prescribed or Permitted by the State of Domicile, for that insurer in the domiciliary state;
- c. The effect of the requested permitted accounting practice on a legal entity basis and on all parent and affiliated United States insurance companies, if applicable; and
- d. Identify any potential effects on and quantify the potential impact to each financial statement line item affected by the request. The potential impact may be determined by comparing the financial statements prepared in accordance with NAIC SAP and the financial statements incorporating the requested permitted accounting practice.

§760. The granting of approval for an accounting practice request by the domiciliary state regulator does not preempt or in any way limit any individual state's legislative and regulatory authority.

### **XI. Financial Statements**

#### **A. Annual Financial Statement**

§861. Each state requires all insurance companies doing business in that state to file an annual financial statement. All states use the annual statement blank promulgated by the NAIC, but each state retains the authority to make changes in those statements. Changes made by states generally require only supplemental information and do not change the basic financial information.

§962. To the extent that disclosures required by a SSAP are made within specific notes, schedules, or exhibits to the annual statement, 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 the SSAPs based on the applicability, materiality and significance of the item to the insurer. Certain disclosures, as noted in individual SSAPs, are required in the annual audited statutory financial statements only.

**B. Interim Financial Statements**

~~60~~63. Interim financial statements, including quarterly statements, shall follow the form and content of presentation prescribed by the domiciliary state for the quarterly financial statements. The NAIC quarterly statement form has been adopted by each state with minor variations as required by certain states.

~~61~~64. The interim financial information shall include disclosures sufficient to make the information presented not misleading. It may be presumed that the users of the interim financial information have read or have access to the annual statement for the preceding period and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies may be determined in that context. Accordingly, footnote disclosure which would substantially duplicate the disclosure contained in the most recent annual statement or audited financial statements, such as a statement of significant accounting policies and practices, details of accounts which have not changed significantly in amount or composition since the end of the most recently completed fiscal year, may be omitted. However disclosure shall be provided where events subsequent to the end of the most recent fiscal year have occurred which have a material impact on the insurer. Disclosures shall encompass, for example, significant changes since the end of the period reported on the last annual statement in such items as: statutory accounting principles and practices, estimates inherent in the preparation of financial statements, status of long term contracts, capitalization including significant new borrowings or modifications of existing financial arrangements, and the reporting entity resulting from business combinations or dispositions. Notwithstanding the above, where material noninsurance contingencies exist, disclosure of such matters shall be provided even though a significant change since year end may not have occurred.

## Permitted Practices Advance Notification Requirement Implementation Questions and Answers

**1. Q: Why is the issue of permitted accounting practices important?**

A: Since the Codification of the NAIC *Accounting Practices and Procedures Manual* (AP&P Manual), there has been continued emphasis on uniformity among the states. With the adoption of Codification, the belief was that permitted accounting practices would be limited. The intent of the policy statement on permitted accounting practices is to provide notification prior to granting permitted accounting practices to other states in which an insurer is licensed. Proactive notification encourages communication between state insurance regulators who share a common interest in the solvency of insurance companies writing business in their state.

**2. Q: What is the difference between a permitted accounting practice and a prescribed practice?**

A: **Permitted** accounting practices include practices specifically requested by an insurer that depart from NAIC Statutory Accounting Principles (SAP) and state prescribed accounting practices, as described below, and have received approval from the insurer's domiciliary state regulatory authority.

**Prescribed** accounting practices are those practices that are incorporated directly or by reference by state laws, regulations and general administrative rules applicable to all insurance enterprises domiciled in a particular state. The NAIC AP&P Manual is not intended to preempt states' legislative and regulatory authority.

If a reporting entity requests an accounting practice that differs from state prescribed accounting practices, but is in accordance with NAIC SAP, advance notice of approval is not required.

**3. Q: Does a permitted accounting practice request require approval/consensus from other states before it is granted by the domiciliary state?**

A: No, the domiciliary state regulatory authority does not need approval or consensus from other state regulatory authorities to grant a permitted accounting practice. The granting of approval for an accounting practice request by the domiciliary state regulator does not preempt or in any way limit any individual state's legislative and regulatory authority.

If a state does not comply with the advance notice provision but approves a permitted practice, the lack of notice does not invalidate the permitted practice for the reporting entity. In addition, the reporting entity is required to disclose accounting practices that depart from the NAIC accounting practices and procedures, which affect statutory surplus or risk based capital pursuant to *SSAP No. 1—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*.

**4. Q: How does the domestic regulator communicate an insurer's request for a permitted accounting practice to other states?**

A: The NAIC can facilitate the communication of this information through the Permitted Practice Database within the Exam Tracking System. In order to develop a repository of all permitted accounting practice notifications, all regulatory authorities should distribute



permitted accounting practice notifications using the procedures prescribed by the NAIC members. When providing permitted accounting practice notifications, the regulatory authority will provide the following information in instances where they are considering approval of a request:

- Detailed description of the permitted accounting practice request, including the specific NAIC Statutory Accounting Principles or state prescribed practices from which the practice departs
- Whether the permitted accounting practice was granted the previous year
- The financial statement filing date in which the permitted accounting practice will be reflected and the timeframe for which the permitted accounting practice is granted (e.g., indefinitely, until withdrawn, specific date – month, day, year)
- Explanation for providing less than the required advance notice
- The financial statement line items the permitted accounting practice will affect and the respective financial impact for each line item identified
- The total financial impact to capital and surplus for all approved/requested permitted accounting practices
- The effect of the permitted accounting practice on a legal entity basis and on all parent and affiliated U.S. insurance companies, if applicable
- Whether the permitted accounting practice is approved or the decision is pending

Grandfather Clause: Please note that those permitted accounting practices that have been granted prior to December 2004 for an indefinite time period do not require a new notice to other states and are not required to be filed through the ETS system. If the permitted accounting practice is considered by the state for reaffirmation annually then annual advance notice is required.

**5. Q: If a Department of Insurance received a request for a permitted accounting practice from an insurer licensed in only one state, is the Department required to comply with communication requirements outlined in the Preamble?**

**A:** No, an insurer licensed in only one state is not subject to the permitted accounting practices communication policy included in the Preamble. The goal of the permitted accounting practices communication policy is to encourage open communication between state regulatory authorities and promote uniformity. As permitted accounting practices granted to an insurer licensed in only one state would not impact states outside of the domiciliary state, they do not need to be communicated to other regulatory authorities.

**6. Q: Are requests for permitted accounting practices kept confidential?**

**A:** The communication of permitted accounting practices will be facilitated through the NAIC's Permitted Practice Database of the Exam Tracking System, which is a confidential, regulator-only system and/or through regulator-to-regulator e-mail exchange.

**7. Q: Is a state required to provide advance notification for accounting practices that are explicitly permitted under the AP&P Manual, with the approval of the commissioner?**

**A:** No, for example, a reporting entity is required to obtain domiciliary commissioner approval for a capital contribution as described in *SSAP No. 72—Surplus and Quasi-Reorganizations*, paragraph 8:

8. Notes or other receivables received as additional capital contributions satisfied by receipt of cash or readily marketable securities prior to filing of the statutory financial

#### Preamble Questions and Answers

statement shall be treated as a Type I subsequent event in accordance with SSAP No. 9 and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

These types of transactions are not a departure from NAIC SAP and do not require a request for a permitted accounting practice.

**8. Q: When will the permitted accounting practices communication policy become effective?**

**A:** The Statutory Accounting Principles (E) Working Group, the Accounting Practices and Procedures (E) Task Force and the Financial Condition (E) Committee held a joint conference call to approve the guidance on November 30, 2004. The policy became effective in December 2004 upon approval by the Executive/Plenary Committee. The policy will be incorporated into the *Accounting Practices and Procedures Manual* and the Financial Regulation Standards and Accreditation (F) Committee will consider such changes to the *NAIC Financial Regulations Standards and Accreditation Manual* during the normal maintenance process.

**9. Q: When submitting a permitted accounting practice request, is the financial statement effect quantified for all affiliates, or only those materially affected?**

**A:** It is important that the insurer identify any potential effects on and quantify the potential impact to each financial statement line item on a legal entity basis and on all parent and affiliated U.S. insurance companies, if applicable. The notification from the regulator should only include the effect on a legal entity basis for those entities materially affected positively or negatively by the permitted accounting practice.