Amendments to specific AICPA pronouncements for changes related to the NAIC codification; Statement of position 01-5;

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

STATEMENT OF POSITION 01-5

AICPA

American Institute of Certified Public Accountants

December 14, 2001

Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification

Issued by the
Accounting Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

1 2 3 4 5 6 7 8 9 0 AccS 0 9 8 7 6 5 4 3 2 1

TABLE OF CONTENTS

SUMMARY

This AICPA Statement of Position (SOP) amends AICPA SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, as a result of the completion of the National Association of Insurance Commissioners (NAIC) Codification of statutory accounting practices for certain insurance enterprises.

The amendments to SOP 94-5 included in this SOP require insurance enterprises to disclose, at the date each balance sheet is presented, beginning with financial statements for fiscal years ending on or after December 15, 2001, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices. Retroactive application is not permitted.

Those disclosures should be made if (*a*) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (*b*) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices, and the use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed.

Those disclosures should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices

that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects.[1]

This SOP also includes the following auditing guidance that has been updated as a result of the completion of the NAIC Codification: AICPA SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*; SOP 94-1, *Inquiries of State Insurance Regulators*; and AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.77). The included auditing guidance has been approved by the Auditing Standards Board.

This SOP is effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements. If comparative financial statements are presented for fiscal years ending before December 15, 2001, the disclosure provisions of SOP 94-5 effective prior to this SOP apply to permitted statutory accounting practices by the regulatory authority.

1. It should be noted that the language of this Statement of Position (SOP) assumes for simplicity that the reporting entity is a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, that prepares U.S. generally accepted accounting principles (GAAP) financial statements. Clarification of the disclosure requirements for a foreign insurance enterprise that does not have a U.S. insurance subsidiary and prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, is noted in footnote 1 of paragraph 8 of the amended SOP 94-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification

Background and Basis for Conclusions

1. In 1999, the National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. The insurance laws and regulations of most states require insurance enterprises domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed or permitted by state law.

2. Prescribed statutory accounting practices are practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence.

3. Permitted statutory accounting practices include practices not prescribed by the domiciliary state, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the prescribed statutory accounting practice or (*b*) if prescribed statutory

accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

4. The revised Manual is effective for implementation on January 1, 2001, as the foundation for statutory accounting practices. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual.

5. This Statement of Position (SOP) amends the guidance in AICPA SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, for changes related to the NAIC Codification. The amendments to SOP 94-5 included in this SOP require a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, that prepares U.S. generally accepted accounting principles (GAAP) financial statements to disclose, at the date each balance sheet is presented, beginning with financial statements for fiscal years ending on or after December 15, 2001, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.[1] The Accounting Standards Executive Committee (AcSEC) believes that this disclosure is useful because it distinguishes both prescribed and permitted practices of insurers by state, and presents statutory surplus of insurers on a comparable basis. AcSEC is aware that certain insurance enterprises domiciled in Bermuda, the Cayman Islands, and other foreign jurisdictions may prepare financial statements in accordance with accounting principles generally accepted in the United States of America even though such

1. The language of this Statement of Position (SOP) assumes for simplicity that the reporting entity is a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, that prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S.GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects.

enterprises do not conduct business in the United States. Additionally, a U.S.-based enterprise may have a foreign domiciled insurance subsidiary and a foreign-based enterprise may have a U.S.-domiciled insurance subsidiary. Because foreign insurance operations (whether they are in a foreign subsidiary of a U.S.-based enterprise, the foreign insurance operations of a foreign-based enterprise that has U.S.-domiciled operations or the foreign insurance operations of a foreign-based enterprise that does not have U.S.-domiciled insurance operations) are not subject to the United States regulatory framework, AcSEC does not believe it is appropriate for those enterprises to determine how the NAIC Codification would affect foreign insurance operations. With respect to their foreign insurance operations, those enterprises should disclose a description of and related monetary effect of any permitted regulatory accounting practices granted by their respective regulatory authority. The disclosure requirements need not apply to a foreign parent that files financial statements in accordance with home country GAAP that are reconciled to accounting principles generally accepted in the United States.

6. This SOP also includes the following auditing guidance that has been updated based on the completion of the NAIC Codification: AICPA SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*; AICPA SOP 94-1, *Inquiries of State Insurance Regulators*; and AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.77). The included auditing guidance has been approved by the Auditing Standards Board.

7. AcSEC believes it is appropriate to have all accounting and auditing guidance that changes due to the completion of the NAIC Codification in one document, because it is easier for readers to review all relevant changes related to this topic. This SOP includes complete sets of updated accounting and auditing guidance, marked to show additions and deletions for changes related to the NAIC Codification. In April 2001, AcSEC issued for public comment an exposure

draft of a proposed SOP, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*. During the forty-five-day comment period, AcSEC received two comment letters.

Amendments to SOP 94-5

8. The following replaces or modifies several paragraphs of SOP 94-5 as a result of the completion of the NAIC Codification. New language is underlined; deleted material is in strikethrough. The changes are effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date. There are no changes to the original paragraphs 9 and 11; those paragraphs are included here for completeness.

> **~~Introduction~~**
>
> ~~1. Most of the accounting principles related to disclosures for insurance enterprises were promulgated over twenty years ago when the insurance regulatory and business environments were less complex and volatile. Accordingly, the AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required in insurance enterprises' financial statements. This statement of position (SOP) is a result of that project.~~
>
> **Scope**
>
> 1.~~2.~~ This <u>Statement of Position</u> (SOP) applies to annual and complete sets of interim financial statements prepared in conformity with generally accepted accounting principles (GAAP) of life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. ~~Furthermore, AICPA Auditing Interpretation No. 12, "Evaluation of the Appro-~~

~~priateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, *Professional Standards*, vol. 1, AU section 9623.60-.79), requires auditors to apply the same disclosure evaluation criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.~~

Applicability to Statutory Financial Statements

2. AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.71), requires auditors to apply the same disclosure evaluation criteria for statutory financial statements and for financial statements prepared in conformity with GAAP.

Relationship to Other Pronouncements

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

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

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

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

Conclusions

4. The disclosure requirements in this section should be read in conjunction with appendix A, "Illustrative Disclosures," item A-2, and appendix B, "Discussion of Conclusions," item B-1. ~~of this SOP.~~

~~Permitted~~ Statutory Accounting Practices

5. ~~Insurance enterprises currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The National Association of Insurance Commissioners (NAIC) currently has a project under way to codify statutory accounting practices through a complete revision of its *Accounting Practices and Procedures Manuals*, that, when complete, is expected to replace prescribed or permitted statutory accounting practices as the statutory basis of accounting for insurance enterprises (referred to hereafter as the "codification"). Therefore, the codification will likely result in changes to what is currently considered a prescribed statutory accounting practice. Furthermore, postcodification permitted statutory accounting practices will be exceptions to the statutory basis of accounting.~~ The insurance laws and regulations of most states require insurance enterprises domiciled in those states to comply with the guidance provided in the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual*, except as prescribed or permitted by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if

not all, provisions of the revised Manual. Auditors of insurance enterprises should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

6. Prescribed ~~precodification~~ statutory accounting practices ~~include~~ are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state~~;~~. ~~*NAIC Annual Statement Instructions*; the *NAIC Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiners' Handbook*.~~ A state may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

7. Permitted statutory accounting practices include practices not prescribed by the domiciliary state as described in paragraph 6 above, but allowed by the domiciliary state ~~insurance department~~ regulatory authority. An ~~I~~insurance enterprises may request permission from the domiciliary state ~~insurance department~~ regulatory authority to use a specific accounting practice in the preparation of ~~their~~ the enterprise's statutory financial statements (*a*) ~~when the enterprise~~ if it wishes to depart from the prescribed statutory accounting practices, or (*b*) ~~when~~ if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

8. The disclosures in this paragraph should be made ~~for permitted statutory accounting practices for the most recent fiscal year presented, regardless of when the permitted statutory accounting practice was initiated.~~ if (*a*) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (*b*) permitted state statu-

tory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices. The disclosures should be made if the use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed. If an insurance enterprise's risk-based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements. Insurance enterprises should disclose, at the date each financial statement is presented, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.[1] ~~Insurance enterprises should disclose the following information about permitted statutory accounting practices that individually or in the aggregate materially affect statutory surplus or risk-based capital, including GAAP practices when the permitted practices differ from the prescribed statutory accounting practices:~~

~~a. A description of the permitted statutory accounting practice~~

~~b. A statement that the permitted statutory accounting practice differs from prescribed statutory accounting practices~~

~~c. The monetary effect on statutory surplus~~

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

1. Disclosures in this paragraph should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S.GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects.

~~*a*. A description of the transaction and of the permitted statutory accounting practice used~~

~~*b*. A statement that prescribed statutory accounting practices do not address the accounting for the transaction~~

Liability for Unpaid Claims and Claim Adjustment Expenses

9. The liability for unpaid claims and claim adjustment expenses represents the amounts needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the statement of financial position date). The estimated liability includes the amount of money that will be required for future payments of (*a*) claims that have been reported to the insurer, (*b*) claims related to insured events that have occurred but that have not been reported to the insurer as of the date the liability is estimated, and (*c*) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees; outside adjuster fees; and costs to record, process, and adjust claims.

10. Financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:

a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable

b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years

c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

Also, insurance enterprises should discuss the reasons for the change in ~~the provision for~~ incurred claims and claim adjustment expenses <u>recognized in the income</u>

statement attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects.

11. In addition to the disclosures required by FASB Statement No. 5 and other accounting pronouncements, insurance enterprises should disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities, such as for claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures.

Effective Dates and Transition

12. ~~This~~ The provisions of this SOP as originally issued in 1994 are ~~is~~ effective for annual and complete sets of interim financial statements for periods ending after December 15, 1994. Disclosures of information required by paragraph 10 should be included for each fiscal year for which an income statement is presented.

13. The provisions of this SOP as amended by AICPA SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, are effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date. Disclosures of information required by amended paragraph 8 and item A-2 in appendix A should be included for each fiscal year for which a balance sheet is presented. In the initial year of implementation of those disclosures, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed as required by the SOP prior to those amendments. Retroactive application of the amendments is not permitted.

Amendments to SOP 94-5, Appendix A

9. The following is from SOP 94-5, appendix A, "Illustrative Disclosures." There are no changes to the original paragraph A-4. That paragraph is included here for completeness. The changes require insurance enterprises to disclose information per item A-2, for annual financial statements for fiscal years ending on or after December 15, 2001, and complete

sets of interim financial statements for periods beginning on or after that date. New language is underlined; deleted material is in strikethrough.

Illustrative Disclosures

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

Prescribed or Permitted Statutory Accounting Practices

A-2. ~~The f~~Following ~~is an~~ are two examples of illustrative~~on of~~ disclosures that an insurance enterprise ~~would~~ could make ~~before the codification is complete,~~ to meet the requirements of paragraph 8, item 8, of this SOP.

Note X. ~~Permitted~~ Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by $2.5 million and $2.3 million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was $30.0 million and $27.9 million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the Company's capital and surplus would have been $29.9 million and $27.7 million at December 31, 20X2 and 20X1, respectively.

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

~~The company received written approval from the ABC State Insurance Department to discount loss reserves at a rate of X percent for statutory accounting purposes, which differs from prescribed statutory accounting practices. Statutory accounting practices prescribed by ABC state require that loss reserves be discounted at Y percent. As of December 31, 19X3, that permitted transaction increased statutory surplus by $XX million over what it would have been had prescribed accounting practice been followed.~~ [1]

~~1. If an insurance company's risk-based capital (RBC) would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements.~~

Note X. Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of the [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP.

The monetary effect on statutory capital and surplus of using accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department is as follows:

	December 31	
	20X2	20X1
	$m	$m
Statutory capital and surplus per statutory financial statements	$30.0	$27.9
Effect of permitted practice of recording home office property at estimated fair value	(2.5)	(2.3)
Effect of [*state of domicile's*] prescribed practice of immediate write-off of goodwill[1]	2.4	2.1
Statutory capital and surplus in accordance with the NAIC statutory accounting practices[2]	$29.9	$27.7

1. This amount compared to the prior year reflects the net impact of an additional year's amortization and the fact that admitted goodwill is based on the level of statutory capital and surplus and thus can fluctuate.

2. In the initial year of implementation of this disclosure, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed as required under the original SOP 94-5.

Liability for Unpaid Claims and Claim Adjustment Expenses

A-3. The following is an illustration of information an insurance enterprise would disclose to meet the requirements of paragraph 10 of this SOP. (This illustration presents amounts incurred and paid net of reinsurance. The information may also be presented before the effects of reinsurance with separate analysis of reinsurance recoveries and recoverables related to the incurred and paid amounts.)

Note X. Liability for Unpaid Claims and Claim Adjustment Expenses

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows.

	~~19X5~~ 20X2	~~19X4~~ 20X1
Balance at January 1	$7,030	$6,687
Less reinsurance recoverables	1,234	987
Net Balance at January 1	5,796	5,700
Incurred related to:		
Current year	2,700	2,600
Prior years	(171)	96
Total incurred	2,529	2,696
Paid related to:		
Current year	781	800
Prior years	2,000	1,800
Total paid	2,781	2,600
Net Balance at December 31	5,544	5,796
Plus reinsurance recoverables	1,255	1,234
Balance at December 31	$6,799	$7,030

As a result of changes in estimates of insured events in prior years, the ~~provision of~~ claims and claim adjustment expenses (net of reinsurance recoveries of $X and $X in ~~19X5~~20X2 and ~~19X4~~20X1, respectively) decreased by $171 million in ~~19X5~~20X2 ~~because of~~ reflecting lower-than-anticipated losses on Hurricane Howard, and increased by $96 million in ~~19X4~~20X1 ~~because of~~ reflecting higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

A-4. The following is an illustration of an insurance enterprise disclosure designed to meet the requirements of paragraph 11 of this SOP. (Additional disclosures about the liabilities for unpaid claims and claim adjustment expenses may be required under FASB Statement No. 5, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, AICPA SOP 94-6, and SEC requirements.)

Note X. Environmental-Related Claims

In establishing the liability for unpaid claims and claim adjustment expenses related to asbestos-related illnesses and toxic waste cleanup, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed and updated continually. Developed case law and adequate claim history do not exist for such claims, especially because significant uncertainty exists about the outcome of coverage litigation and whether past claim experience will be representative of future claim experience.

Amendments to SOP 94-5, Appendix B

10. The following is from SOP 94-5, appendix B, "Discussion of Conclusions," when the SOP was originally issued in 1994. Sections B-1, B-4, B-5, B-6, B-7, and B-14 have been revised as a result of the completion of the NAIC Codification. The remaining sections are included for background information about prior AcSEC discussions. New language is underlined; deleted material is in strikethrough.

Discussion of Conclusions

B-1. In 1999, the National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. This SOP was updated in 2001 to conform to the revised Manual. This section discusses factors that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this SOP when it was originally issued in 1994. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

B-2. The business and regulatory environment of insurance enterprises has become more complex and volatile, and therefore riskier. Accordingly, AcSEC believed the need existed to reconsider the disclosures made in the financial statements of insurance enterprises.

B-3. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). Further, the Concepts Statement says that to support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprises" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources. . . and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40).

B-4. AcSEC considered a wide variety of potential disclosures, and tried to identify the areas of importance to insurance enterprises for which the current disclosures were lacking. AcSEC concluded that additional disclosures in the financial statements of insurance enterprises about regulatory risk-based capital, the liability for unpaid claims, and certain accounting methods permitted by state ~~insurance departments~~ regulatory authorities would help insurance enterprises better meet the objectives of financial reporting in their financial statements. After the completion of the NAIC codification, AcSEC concluded that additional disclosures reconciling statutory surplus between statutory financial statements (including permitted practices), state prescribed basis, and in accordance with NAIC statutory accounting practices would be useful to the reader of generally accepted accounting principles (GAAP) financial statements. AcSEC is aware that certain insurance enterprises domiciled in Bermuda, the Cayman Islands, and other foreign jurisdictions may prepare financial statements in accordance with accounting principles generally accepted in the United States even though such enterprises do not conduct business in the United States. Additionally, a U.S.-based enterprise may have a foreign-domiciled insurance subsidiary and a foreign-based enterprise may have a U.S.-domiciled insurance subsidiary. Because the foreign insurance operations of such enterprises (whether they are in a foreign subsidiary of a U.S.-based enterprise, the foreign insurance operations of a foreign-based enterprise that has U.S.-domiciled operations or the foreign insurance operations of a foreign-based enterprise that does not have U.S.-domiciled insurance operations) are not subject to the United States regulatory framework, AcSEC does not believe it is appropriate for those enterprises to determine how the NAIC codification would affect foreign insurance operations. With respect to their foreign insurance operations, those enterprises should disclose a description of and related monetary effect of any permitted regulatory accounting practices granted by their respective regulatory authority. The disclosure requirements need not apply to a foreign parent that files financial statements in accordance with home country GAAP that are reconciled to accounting principles generally accepted in the United States.

Risk-Based Capital

B-5. Insurance enterprises operate in a highly regulated environment directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the insurance system. Historically, regulation of insurance enterprises has monitored solvency by focusing on their capital. One of the primary tools used by state ~~insurance departments~~ regulatory authorities for ensuring that their objectives are being met is risk-based capital (RBC).

B-6. The NAIC has developed an RBC program that is used by state regulatory authorities ~~insurance departments~~ to enable them to take appropriate and timely regulatory actions relating to insurers that show signs of weak or deteriorating financial conditions. This program is encompassed in the RBC Model Acts for life and property and casualty insurers, which have been or are intended to be adopted by most of the states. RBC is a series of dynamic surplus-related formulas set forth in the NAIC's RBC instructions for life and health and for property and casualty insurance enterprises. The formulas contain a variety of weighing factors that are applied to financial balances or to levels of activity based on the perceived degree of certain risks, such as asset risk, credit risk, interest rate risk (life insurance enterprises only), underwriting risk, and other business risks, such as risks related to management, regulatory action, and contingencies. The amount determined under such formulas, the authorized control level risk-based capital, is required to be disclosed in life insurance enterprises' statutory filings starting for the year ended December 31, 1993, and in property and casualty insurance enterprises' statutory filings starting for the year ended December 31, 1994.

B-7. The exposure draft of the SOP that was originally issued in 1994 contained a requirement that insurance enterprises that are required to calculate RBC should disclose in their financial statements the ratio of total adjusted capital to authorized control level RBC and the amount of total adjusted capital for each fiscal year for which a statement of financial position is presented.

B-8. However, the NAIC's RBC Model Acts for both life and property and casualty insurers have a confidentiality provision, which states:

> [E]xcept as otherwise required under the provisions of this Act [that is, in the annual financial reports filed with state insurance departments], the making, publishing, disseminating, circulation, or placing before the public, or causing, directly or indirectly to be made, placed before the public, in a newspaper, magazine or other publication . . . with regard to the RBC levels of any insurer . . . would be misleading and is therefore prohibited.

B-9. Prior to issuing the exposure draft, based on discussions with the drafters of the RBC Model Acts and some state insurance regulators, and based on the fact that the information is already in the public domain, AcSEC believed that the confidentiality provisions were not intended to apply to disclosures in financial statements. However, a number of respondents to the exposure draft stated that they believe disclosing RBC levels in financial statements would be illegal in states that have enacted the RBC Model Acts. They point out that words in the RBC Model Acts appear to be intended to restrict *all* other disclosure of RBC levels, including in insurers' financial statements.

B-10. AcSEC continues to believe, because of the importance of RBC in the regulatory oversight of insurance enterprises, that its disclosure would improve the relevance and usefulness of insurance enterprises' financial statements, and, therefore, it should be disclosed in the financial statements. Nevertheless, AcSEC concluded the legal issues require further consideration.

B-11. AcSEC decided that this SOP should not be delayed while the legal issues regarding RBC disclosures are considered. A separate SOP on RBC disclosures will be considered at a later date.

B-12. Nevertheless, AcSEC encourages insurance enterprises to disclose RBC levels if they are domiciled in states that have not adopted the RBC Model Acts, or if they have otherwise determined that it is legal to make such disclosures in their financial statements.

B-13. The exposure draft also required insurance enterprises whose level of RBC has triggered a regulatory event[21] to disclose certain information in their financial statements. Delaying the issuance of the RBC guidance does not change the fact that under Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, auditors must consider the need for disclosures about the principal conditions and events that triggered the regulatory event and the possible effects of such conditions and events, as well as management's plans.

---

21. Under the NAIC's RBC Model Acts, when the ratio of total adjusted capital to authorized control level RBC is less than or equal to 2 or less than or equal to 2.5 with negative trends for life insurance enterprises, a regulatory event exists—that is, the insurance enterprise would fail to meet the minimum RBC requirements. There are four types of regulatory events, ranging from least to most serious: company action level event, regulatory action level event, authorized control level event, and mandatory control level event.

Permitted Statutory Accounting Practices

B-14. Permitted statutory accounting practices historically have not been disclosed in the notes to the financial statements, except to the extent that they have been disclosed in the accounting practices and procedures note to the statutory financial statements. With increasing frequency, insurance enterprises have transactions that are not explicitly addressed by prescribed accounting practices, or for which no analogous prescribed accounting practices exist. Furthermore, insurance enterprises often request exceptions from certain prescribed accounting practices. Permitted statutory accounting practices may differ from state to state, and from company to company within a state, and may change in the future. Moreover, permitted statutory accounting practices have been used to enhance insurance enterprises' surplus positions. For example, some state ~~insurance departments~~ regulatory authorities have permitted certain insurance enterprises to adjust home office facilities to appraised values even though the states' prescribed statutory accounting practices require that such assets be carried at depreciated historical cost.

B-15. AcSEC believes the required disclosure of permitted statutory accounting practices will enhance the relevance of the financial statements and fulfill the financial reporting objective of providing current and potential investors, creditors, policyholders, and other users of an insurance enterprise's financial statements with useful information. Not only will such disclosures identify situations in which permitted statutory accounting practices enhance an insurance enterprise's statutory capital and RBC position, but they also will improve the comparability of insurance enterprises' financial statements.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-16. Insurance enterprises estimate their liability for unpaid claims and claim adjustment expenses for reported and unreported claims incurred as of the end of the accounting period in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. The liability is estimated based on past loss experience, adjusted for current trends and other factors that will modify past experience. The liability may be calculated using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

B-17. FASB Concepts Statement No. 1, paragraph 21, states:

> The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. Management may communicate information about its plans or projections, but financial statements and most other financial reporting are historical . . . . Estimates resting on expectations of the future are often needed in financial reporting, but their major use, especially

> of those formally incorporated in financial statements, is to measure financial effects of past transactions or events or the present status of an asset or liability . . . . To provide information about the past as an aid in assessing the future is not to imply that the future can be predicted merely by extrapolating past trends or relationships. Users of the information need to assess the possible or probable impact of factors that may cause change and form their own expectations about the future and its relation to the past.

B-18. AcSEC believes that disclosures about an insurance enterprise's liabilities for unpaid claims and claim adjustment expenses development are useful in understanding the insurance enterprise's liabilities and results of operations. Furthermore, AcSEC notes the disclosures are the same as some of the loss reserve development disclosures that the SEC requires registrants to file with the commission under Securities Act Guide 6.

B-19. Paragraph 60(a) of FASB Statement No. 60~~, *Accounting and Reporting by Insurance Enterprises*,~~ requires all insurance enterprises to disclose the basis for estimating the liabilities for unpaid claims and claim adjustment expenses. Furthermore, FASB Statement No. 5, *Accounting for Contingencies*, requires disclosure of loss contingencies not accrued, for which it is at least reasonably possible that a loss has been incurred. Because of the relatively high degree of coverage litigation and the lack of historical information regarding the amount and nature of both known and unasserted claims relating to difficult-to-estimate liabilities (such as those related to environmental related illness claims and toxic-waste cleanup claims), traditional loss reserving techniques may not be used in estimating such liabilities. Therefore, a high degree of judgment is needed in estimating the amount of losses, and practice is developing in the area. Accordingly, AcSEC believes financial statement users will benefit from disclosure of the policies and methods management has used for estimating these amounts.

Discussion of Comments Received on Exposure Draft

B-20. An exposure draft of a~~n~~ S~~s~~tatement of P~~p~~osition (SOP), *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*, was issued on April 20, 1994, and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Forty comment letters were received on the exposure draft.

Risk-Based Capital

B-21. A number of comments were received on the risk-based capital disclosures. As discussed in paragraphs B-5 through B-13, AcSEC decided to consider a separate SOP at a later date on risk-based capital disclosures. The comments will be addressed at that time.

Permitted Statutory Accounting Practices

B-22. A number of respondents to the exposure draft of the SOP requested that the disclosure requirements for permitted statutory accounting practices be postponed until after the codification is complete. AcSEC believes that the disclosures are especially important before codification to improve understanding of the factors that affect comparability among the statutory capital of insurance enterprises.

B-23. Respondents asked for clarification of how disclosure of the monetary effect of statutory surplus would be calculated, particularly when there is no prescribed accounting practice to compare with the permitted practice. AcSEC agreed and revised the exposure draft to state that for permitted statutory accounting practices used when prescribed accounting practice is silent, a description of the transaction is sufficient. Respondents also asked for clarification about whether there should be disclosure of GAAP-permitted practices when there is no prescribed statutory accounting. If an insurance company uses a GAAP practice in its statutory financial statements when there is no prescribed practice, that is still considered a permitted statutory accounting practice. However, AcSEC agreed that no disclosures should be made for GAAP practices that are used when prescribed statutory practices do not specify the accounting for the transaction.

B-24. Respondents suggested that the requirement in the exposure draft to make a statement about the codification be eliminated. AcSEC agreed the disclosure might be confusing to users of financial statements, and eliminated the requirement.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-25. The exposure draft would have required disclosure of information about actuarial adjustments made for nonrecurring or abnormal experience. A number of respondents suggested that that disclosure requirement be eliminated. AcSEC was persuaded that such actuarial adjustments are a normal part of making estimates that should not be disclosed in the financial statements and eliminated the requirement.

Amendments to SOP 95-5

11. The following replaces or modifies several paragraphs of SOP 95-5 as a result of the completion of the NAIC Codification, as well as other conforming changes, including SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), and SAS No. 93, *Omnibus Statement on Auditing Standards—2000* (AICPA, *Professional Standards*, vol. 1, AU secs. 315, 508, and 622). New language is underlined; deleted material is in strikethrough. The changes are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. There are no changes to the original paragraph 23; that paragraph is included here for completeness.

Introduction and Background

1. All states require domiciled insurance enterprises to submit to the state insurance commissioner an annual statement on forms developed by the National Association of Insurance Commissioners (NAIC). The states also require that audited statutory financial statements be provided as a supplement to the annual statements. ~~Currently, s~~Statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the ~~insurance department~~ regulatory authority of the state of domicile," referred to in this Statement of Position (SOP) as ~~*prescribed or permitted*~~ *statutory accounting* practices. Statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) as described in Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623).

2. ~~The NAIC is in the process of codifying statutory accounting practices for certain insurance enterprises. When the NAIC completes the codification of statutory ac-~~

~~counting practices (the codification), it is expected that the states will require that statutory financial statements be prepared using accounting practices "prescribed in the NAIC's *Accounting Practices and Procedures Manual*," referred to in this SOP as *NAIC codified statutory accounting*.~~ The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as otherwise prescribed by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of an insurance enterprise should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

~~3.~~ ~~This SOP is intended to apply to audits of statutory financial statements pre- and post-codification. The term *statutory basis of accounting* is used in this SOP to refer to whatever is accepted as the statutory basis of accounting; currently, that is prescribed or permitted statutory accounting. When codification is complete, it is expected that the statutory basis of accounting will be NAIC codified statutory accounting.~~

Prescribed-or-Permitted Statutory Accounting Practices

3.~~4.~~ Prescribed statutory accounting practices ~~currently~~ are those practices that are incorporated directly or by reference ~~included~~ in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state.~~; t. The NAIC *Annual Statement Instructions*; the NAIC *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiner's Handbook*.~~ States may adopt the revised Manual in whole or in part as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

4. ~~5.~~ Permitted statutory accounting practices include practices not prescribed ~~in the sources~~ by the domiciliary state as described in paragraph 4 3, above, but allowed by the domiciliary state ~~insurance department~~ regulatory authority. An ~~I~~insurance enterprises may request permission from the domiciliary state ~~insurance department~~ regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) ~~when~~ if it wishes to depart from the state prescribed statutory accounting practices, or (*b*) ~~when~~ if prescribed statutory accounting practices do not address the accounting for the transaction~~(s)~~. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

~~*NAIC Codified Statutory Accounting*~~

~~6. The NAIC undertook the project to codify statutory accounting practices because the current prescribed or permitted statutory accounting model results in practices that may vary widely—not only from state to state, but for insurance enterprises within a state. 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. Current statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) under Statement on Auditing Standards (SAS) No. 62, *Special Reports*. When codification is complete, it is anticipated that a statutory basis of accounting for insurance enterprises other than NAIC codified statutory accounting will be considered neither generally accepted accounting principles (GAAP) nor OCBOA. [1] SAS No. 62, paragraphs 27 to 30, provides guidance on reporting on financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or OCBOA. That guidance is for financial statements prepared in accordance with an agreement (for example, a loan agreement) and that form of report should not be used for statutory financial statements of insurance enterprises.~~

~~1. When the codification is complete, certain amendments to SAS No. 62 would be required.~~

Other Relevant AICPA Pronouncements

5.~~7.~~ During 1994, the AICPA issued the following two pronouncements that address statutory accounting practices and statutory financial statements. These documents were amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*.

a. SOP 94-1, *Inquiries of State Insurance Regulators*, requires, for each audit, auditors to obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the ~~insurance department~~ regulatory authority of the state of domicile.

b. SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, requires insurance enterprises to disclose information about prescribed and permitted statutory accounting practices in their financial statements.

Applicability

6.~~8.~~ This SOP applies to all audits of statutory financial statements of insurance enterprises that file financial statements with state regulatory authorities ~~insurance departments~~, including stock and mutual insurance enterprises. Insurance enterprises that prepare statutory financial statements include life and health insurance enterprises, property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools, syndicates, captive insurance companies, financial guaranty insurance enterprises, health maintenance organizations, and hospital, medical, and dental service or indemnity corporations.

7.~~9.~~ This SOP supersedes SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies*. It also amends the AICPA Audit and Accounting Guides *Audits of Property and Liability Insurance Companies* and *Life and Health Insurance Entities*. ~~the AICPA Industry Audit Guide Audits of *Stock Life Insurance Companies*.~~[2]

~~2. The AICPA is revising the Audit and Accounting Guide *Audits of Life and Health Insurance Entities*, which will incorporate this SOP.~~

Conclusions

Superseding Statement of Position 90-10, Reports on Audited Financial Statements of Property and Liability Insurance Companies

8.~~10.~~ Auditors should not issue reports on statutory financial statements as to fair presentation in conformity with ~~the~~ statutory accounting practices ~~basis of accounting~~ that include a disclaimer of opinion as to fair presentation in conformity with generally accepted accounting principles (GAAP).

General-Use ~~Distribution~~ Reports

9.~~11.~~ ~~Under SAS No. 62,~~ ~~i~~If an insurance enterprise's statutory financial statements are intended for distribution other than for filing with the regulatory authorities ~~insurance departments~~ to whose jurisdiction the insurance enterprise is subject, the auditor of those statements should use the general-use ~~distribution~~ form of report for financial statements that lack conformity with GAAP (SAS No. 62, *Special Reports* [AICPA, *Professional Standards*, vol. 1, AU sec. 623]).~~Paragraph .04 in~~ SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 544.04, "Lack of Conformity With Generally Accepted Accounting Principles")~~*Lack of Conformity With Generally Accepted Accounting Principles*, (AICPA, *Professional Standards*, vol. 1, AU sec. 544)~~, requires the auditor to use the standard form of report described in SAS No. 58, Reports on Audited Financial Statements (AICPA, *Professional Standards*, vol. 1, AU sec. 508), modified as appropriate because of departures from GAAP.

10.~~12.~~ Although it may not be practicable to determine the amount of difference between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~, the nature of the differences is known. The differences generally exist in significant financial statement items, and are believed to be material and pervasive to most insurance enterprises' financial statements. Therefore, there is a rebuttable presumption that the differences between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~ are material and pervasive. ~~Therefore,~~ ~~a~~Auditors should express an adverse opinion with respect to conformity with GAAP ~~(refer to SAS No. 58, paragraph 67)~~ (AU sec. 508.58), unless the auditor determines the differences between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~ are not material and pervasive.

11.~~13.~~ ~~Paragraphs 68 and 69 in SAS No. 58 requires an~~ The auditor, when expressing an adverse opinion, is required to disclose in a separate explanatory paragraph(s) preceding the opinion paragraph in his or her report (*a*) all of the substantive reasons for the adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable[~~3~~1] (AU sec. 508.59 and .60). If the effects are not reasonably determinable, the report should so state, and also should state that the differences are presumed to be material. Furthermore, the notes to the statutory financial statements should discuss ~~the~~ statutory accounting practices ~~basis of accounting~~ and describe how those practices differ from GAAP.

12.~~14.~~ After expressing an ~~adverse or qualified~~ opinion on the statutory financial statements as to conformity with GAAP, auditors may express an opinion on whether the statutory financial statements are presented in conformity with ~~the~~ statutory accounting practices. ~~basis of accounting under SAS No. 1, section 544. If, as anticipated, NAIC codified statutory accounting becomes the statutory basis of accounting, an accounting practice that departs from that basis of accounting, regardless of whether required by state law or permitted by state regulators, would be considered an exception to the statutory basis of accounting. Accordingly,~~ If ~~such~~ departures from statutory accounting practices are found to exist and are considered to be ~~are~~ material, the auditors should express a qualified or adverse opinion on the statutory financial statements just as they would under SAS No. 58 regarding conformity with GAAP.[~~4~~]

~~3~~1 SAS No. 32, *Adequacy of Disclosure in the Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 431), defines practicable as "the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information." For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the auditor's report.

~~4. See footnote 1.~~

13.~~15.~~ Following is an illustration of an independent auditor's report on the general-use ~~distribution statutory~~ financial statements of an insurance enterprise prepared in conformity with ~~prescribed or permitted~~ statutory accounting practices, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with ~~the~~ statutory accounting practices ~~basis of accounting~~. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~ are not reasonably determinable.

Independent Auditor's Report

To the Board of Directors
ABC Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, ~~19~~20X2 and ~~19~~20X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with ~~generally accepted~~ auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*],[5] which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between ~~the~~

statutory accounting practices ~~basis of accounting~~ and ~~generally accepted~~ accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with ~~generally accepted~~ accounting principles generally accepted in the United States of America, the financial position of ABC Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, or the results of its operations or its cash flows for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

~~5. If, as anticipated, NAIC codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's *Accounting Practices and Procedures Manual*," or other appropriate language.~~

Limited-Use ~~Distribution~~ Reports

14.~~16.~~ Prescribed-or-permitted statutory accounting practices for insurance enterprises ~~currently is~~ are considered an OCBOA as described in SAS No. 62. If an insurance enterprise's statutory financial statements are intended solely for filing with state regulatory authorities ~~insurance departments~~ to whose jurisdiction the insurance enterprise is subject, the auditor may use the form of report for financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP. ~~Paragraph .05f of SAS No. 62 recognizes that~~Such reporting is appropriate even though the auditor's report may be made a matter of public record (AU sec. 623.05f). However, that paragraph further states that limited-use ~~distribution~~ reports may be used only if the financial statements and report are intended solely for filing with the regulatory agencies to whose jurisdiction the insurance enterprise is subject. The auditor's report should contain a statement that there is a restriction on ~~distribution~~ the use of the statutory financial statements to those within the insurance enterprise and for filing with the state regulatory authorities ~~insurance departments~~ to whose jurisdiction the insurance enterprise is subject.

15.~~17.~~ Although auditing standards do not prohibit an auditor from issuing limited-use ~~distribution~~ and general-use ~~distribution~~ reports on the same statutory financial statements of an insurance enterprise, it is preferable to issue only one of those types of reports. Few, if any, insurance enterprises that do not prepare financial statements in ~~accordance~~ conformity with GAAP will be able to fulfill all of their reporting obligations with limited-use ~~distribution~~ statutory financial statements.

16.~~18.~~ Following is an illustration, adapted from paragraph 8 of SAS No. 62, of an unqualified auditor's report on limited-use ~~distribution statutory~~ financial statements prepared in conformity with ~~prescribed or permitted~~ statutory accounting practices.

Independent Auditor's Report

To the Board of Directors
XYZ Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, and the related statutory statements of income and changes in surplus, and cash flows, for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with ~~generally accepted~~ auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*],~~6~~ which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and the management of XYZ Insurance Company and state insurance departments to whose jurisdiction the company is subject and is not intended to be and should not be used by anyone other than these specified parties.

~~6. If, as anticipated, NAIC codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's *Accounting Practices and Procedures Manual*," or other appropriate language.~~

~~19. In accordance with paragraph 10 of SAS No. 62, the notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discusses the statutory basis of accounting and describes how the basis differs from GAAP. However, the effects of the differences need not be quantified.~~

General-Use and Limited-Use ~~Distribution~~ Reports

17. The notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discuss statutory accounting practices and describe how this basis differs from GAAP (AU sec. 623.10). In general-use statutory financial statements, the effects of the differences should be disclosed, if quantified. However, in limited-use statutory financial statements, the effects of the differences need not be quantified or disclosed.

18.~~20.~~ The auditor should consider the need for an explanatory paragraph (or other explanatory language) under the circumstances described in ~~paragraph 11 of~~

SAS No. 58 (AU sec. 508.11) and ~~paragraph 31 of~~ SAS No. 62 (AU sec. 623.31) regardless of any of the following:

a. The type of report—general-use or limited-use ~~distribution~~

b. The opinion expressed—unqualified, qualified, or adverse

c. Whether the auditor is reporting as to conformity with GAAP or conformity with the statutory accounting practices ~~basis of accounting~~

For example, in a general-use ~~distribution~~ report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to conformity with the statutory accounting practices ~~basis of accounting~~, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance enterprise's ability to continue as a going concern; such paragraph should follow both opinion paragraphs.

19.~~21.~~ ~~As discussed in paragraph 37 of SAS No. 58 and paragraph 31 of SAS No. 62, in a separate paragraph of the auditors report, t~~The auditor may wish to emphasize a matter in a separate paragraph of the auditor's report (AU secs. 508.37 and 623.31). When an insurance enterprise prepares its financial statements using accounting practices prescribed or permitted by the ~~insurance department~~ regulatory authority of the state of domicile and has significant transactions that it reports using permitted accounting practices that materially affect the insurance enterprise's statutory capital,~~[7]~~ the auditor is strongly encouraged to include an emphasis-of-a-matter paragraph in the report describing the permitted practices and their effects on statutory capital.

20.~~22.~~ An example of an emphasis-of-a-matter paragraph follows:

> As discussed in Note X to the financial statements, the Company received permission from the Insurance Department of the [*state of domicile*] in 20~~19~~XX to write up its home office property to appraised value; under prescribed statutory accounting practices home office property is carried at depreciated cost. As of December 31, 20~~19~~X5, that permitted accounting practice increased statutory surplus by $XX million over what it would have been had the prescribed accounting practices been followed.

~~7. If, as anticipated, NAIC codified statutory accounting replaces the prescribed or permitted statutory basis of accounting, such permitted practices would be considered departures from the statutory basis of accounting.~~

21. If subsequent to the initial adoption of the revised Manual there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of the company's financial statements, the auditor should refer to the change in an explanatory paragraph of the report (AU sec. 508.16). The explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer to the note in the financial statements that discusses the change. The auditor's concurrence with a change is implicit, unless the auditor takes exception to the change in expressing the opinion as to the fair presentation of the financial statements in conformity with GAAP or the statutory accounting practices.

22. An example of an explanatory paragraph follows:

> As discussed in Note X to the financial statements, the Company changed its method of accounting for guaranty funds and other assessments.

Mutual Life Insurance Enterprises

23. In April 1993, the Financial Accounting Standards Board (FASB) issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that mutual life insurance enterprises can no longer issue statutory financial statements that are described as "in conformity with generally accepted accounting principles." Interpretation No. 40, as amended by FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, is effective for financial statements issued for fiscal years beginning after December 15, 1995. (FASB Statement No. 120 does not change the disclosure and other transition provisions of Interpretation No. 40.) For statutory financial statements of mutual life insurance enterprises issued before that effective date, auditors may report on the statutory financial statements as being in conformity with generally accepted accounting principles.

Effective Dates

24. ~~This~~The provisions of this SOP as originally issued in 1995 should be applied to audits of statutory financial statements for years ended on or after December 31, 1996. The amendments to this SOP are effective for audits of statutory fi-

nancial statements for fiscal years ending on or after December 15, 2001. Retroactive application is not permitted.

Amendments to SOP 94-1

12. The following replaces or modifies several paragraphs of SOP 94-1 as a result of the completion of the NAIC Codification. New language is underlined; deleted material is in strikethrough. The changes are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. There are no changes to the original paragraphs 1 and 4; those paragraphs are included here for completeness.

Introduction

1. This S~~s~~tatement of P~~p~~osition (SOP) addresses the auditor's consideration of regulatory examinations as a source of evidential matter in conducting an audit of an insurance enterprise's financial statements and the auditor's evaluation of material permitted statutory accounting practices.

Applicability

2. This SOP applies to audits of financial statements of life insurance enterprises,[1] property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. It amends chapters 2 ("Audit Considerations") of the AICPA Audit and Accounting Guides *Audits of Property and Liability Insurance Companies* and *Life and Health Insurance Entities*~~chapter 9 ("Auditing Procedures") of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*.[2]~~

1. FASB Intrepretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, clarifies that FASB Statements and Interpretations and Accounting Principles Board (APB) Opinions apply to mutual life insurance enterprises, except when specifically exempted, that prepare financial statements in conformity with generally accepted accounting principles. This SOP applies to audits of mutual life insurance enterprises.

~~2. The AICPA's Insurance Companies Committee technical agenda includes a project to supersede the Industry Audit Guide *Audits of Stock Life Insurance Companies*. The new Audit and Accounting Guide *Audits of Life and Health Insurance Enterprises* will include the guidance contained in this SOP.~~

3. The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of an insurance enterprise should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

Auditor's Consideration of State Regulatory Examinations

4.~~3.~~ ~~Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates*, states that t~~The auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies~~.~~" (Statement on Auditing Standards [SAS] No. 57, *Auditing Accounting Estimates* [AICPA, *Professional Standards*, vol. 1, AU sec. 342]). ~~SAS No. 54, *Illegal Acts by Clients*, notes that "t~~The auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been available to the auditor~~.~~" (SAS No. 54, *Illegal Acts by Clients* [AICPA, *Professional Standards*, vol. 1, AU sec. 317]). Accordingly, it is appropriate that the auditor review examination reports and related communications between regulators and the insurance enterprise to obtain competent evidential matter.

5.~~4.~~ The auditor should review reports of examinations and communications between regulators and the insurance enterprise and make inquiries of the regulators. The auditor should—

- Request that management provide access to all reports of examinations and related correspondence including correspondence relating to financial conditions.
- Read reports of examinations and related correspondence between regulators and the insurance enterprise during the period under audit through the date of the auditor's report.

- Inquire of management and communicate with the regulators, with the prior approval of the insurance enterprise, when the regulators' examination of the enterprise is in process or a report on an examination has not been received by the insurance enterprise regarding conclusions reached during the examination.

6.~~5.~~ A refusal by management to allow the auditor to review communications from, or to communicate with, the regulator would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion. (~~See~~ SAS No. 58, *Reports on Audited Financial Statements*, [AICPA, *Professional Standards*, vol. 1, AU sec. 508]). A refusal by the regulator to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances.

Auditor's Consideration of Permitted Statutory Accounting Practices

7.~~6.~~ Prescribed statutory accounting practices ~~currently include~~ are those practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. ~~; the National Association of Insurance Commissioners (NAIC) Annual Statement Instructions; the NAIC *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the *NAIC Examiners' Handbook*.~~ States may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

8.~~7.~~ Permitted statutory accounting practices include practices not prescribed by the domiciliary state, as described in paragraph ~~6~~7 above, but allowed by the domiciliary state ~~insurance department~~ regulatory authority. An insurance enterprise~~s~~ may request permission from the domiciliary state ~~insurance department~~ regulatory authority to use a specific accounting practice in the preparation of ~~their~~ the enterprise's statutory financial statements (*a*) ~~when the enterprise~~ if it wishes to depart from the prescribed statutory accounting practices, or (*b*) ~~when~~ if prescribed statutory accounting practices do not address the accounting for the transaction~~(s)~~. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

9.~~8.~~ Auditors should exercise care in concluding that an accounting treatment is *permitted*, and should consider the adequacy of disclosures in the financial statements regarding such matters.~~[3]~~ For each examination, auditors should obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are ~~material~~ significant to an insurance enterprise's financial statements are permitted by the domiciliary state ~~insurance department~~ regulatory authority.

10.~~9.~~ Sufficient competent evidential matter consists of any one or combination of—

- Written acknowledgment sent directly from the regulator to the auditor. (This type of corroboration includes letters similar to attorneys' letters and responses to confirmations.)
- Written acknowledgment prepared by the regulator, but not sent directly to the auditor, such as a letter to the client.
- Direct oral communications between the regulator and the auditor, supported by written memorandum. (If the auditor, rather than the regulator, prepares the memorandum, the auditor should send such memorandum to the regulator to make sure it accurately reflects the communication.)

~~3. The AICPA has issued an exposure draft of a statement of position, *Disclosures of Certain Matters in Financial Statements of Insurance Enterprises*, that would require insurance enterprises to disclose information about permitted statutory accounting practices in their financial statements prepared in conformity with generally accepted accounting principles.~~

Auditors should use judgment to determine the type of corroboration that is necessary in the circumstances.

11.~~10.~~ If the auditor is unable to obtain sufficient competent evidential matter to corroborate management's assertion regarding a permitted statutory accounting practice that is material to the financial statements, the auditor should qualify or disclaim an opinion on the statutory financial statements because of the limitation on the scope of the audit~~.~~ (~~See~~ SAS No. 58~~,~~. ~~*Reports on Audited Financial Statements*.~~).

Effective Dates

12.~~11.~~ ~~This~~The provisions of this SOP as originally issued in 1994 should be applied to audits of financial statements performed for periods ending on or after December 15, 1994. The amendments to this SOP are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. Retroactive application is not permitted.

Amendments to Interpretation No. 12 of SAS No. 62

13. The following replaces or modifies several paragraphs of Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of SAS No. 62, *Special Reports*, as a result of the completion of the NAIC Codification. New language is underlined; deleted language is in strikethrough.

Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis

.60 *Question*—Insurance enterprises issue financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators (a "statutory basis") in addition to, or instead of, financial statements prepared in accordance with generally accepted accounting principles (GAAP). Effective January 1, 2001, most states are expected to adopt a comprehensively updated *Accounting Practices and*

Procedures Manual, as revised by the National Association of Insurance Commissioners' (NAIC's) Codification project. The updated *Accounting Practices and Procedures Manual*, along with any subsequent revisions, is referred to as the revised Manual. The revised Manual contains extensive disclosure requirements. As a result, after a state adopts the revised Manual, its statutory basis of accounting will include informative disclosures appropriate for that basis of accounting. The NAIC Annual Statement Instructions prescribe the financial statements to be included in the annual audited financial report. Some states may not adopt the revised Manual or may adopt it with significant departures. How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate?[1]

.61 *Interpretation*—Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to ~~section 623~~ SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04). ~~Section 623.09~~ SAS No. 62 (AU sec. 623.09) states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting ~~as he or she does~~ as those applied to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraph .04.

1. It is possible for one of three different situations to occur: The state adopted the revised Manual without significant departures, adopted the revised Manual with significant departures, or has not yet adopted the revised Manual.

.62 SAS No. 62 ~~Section~~ (AU sec. 623.02) states that generally accepted auditing standards apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Thus, in accordance with the third standard of reporting, "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

.63 *Question*—What types of items or matters should auditors consider in evaluating whether informative disclosures are reasonably adequate?

.64 *Interpretation*~~—Section~~ SAS No. 62 (AU sec. 623.09 and .10) indicates that financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used~~,~~. That includes ~~including~~ a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. ~~Section~~ SAS No. 62 (AU sec. 623.10) also states that when "the financial statements [prepared on an other comprehensive basis of accounting] contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate."

~~.65 In addition, in 1991, the National Association of Insurance Commissioners (NAIC) has adopted new Annual Statement instruction, *Annual Audited Financial Reports*, under which insurance enterprises are required to include in their statutory basis financial statements those disclosures that "are appropriate to a CPA audited financial report, based on applicability, materiality and significance, taking into account the subjects covered in the instructions to and illustrations of how to report information in the notes to the financial statements section of [the] Annual Statement instructions and any other notes required by generally accepted accounting principles...." The laws and regulations of some individual states contain similar requirements.~~

~~.66. Therefore, the auditor should also consider the disclosures and illustrations of how to report information in the notes to financial statements section of the Annual Statement instructions.~~

.65~~.67~~ *Question*—How does the auditor evaluate whether "similar informative disclosures" are appropriate for—

a. Items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP?

b. Items and transactions that are accounted for differently under a statutory basis than under GAAP?

c. Items and transactions that are accounted for differently under requirements of the state of domicile than under the revised Manual?

.66~~.68~~ *Interpretation*—Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially the same or in a similar manner under ~~a~~ the statutory basis as under GAAP should be the same as, or similar to, the disclosures required by GAAP unless the revised Manual specifically states the NAIC Codification rejected the GAAP disclosures. Disclosures should also include those required by the revised Manual. ~~Other disclosures considered necessary upon review of the Annual Statement instructions should also be made to the extent that such disclosures are significant to the statutory basis financial statements.~~

~~.69 For example, disclosures in statutory basis financial statements concerning financial instruments should include the applicable disclosures required by FASB Statement No. 60,~~ ~~*Accounting and Reporting by Insurance Enterprises*~~~~, FASB Statement No. 105,~~ ~~*Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*~~~~, FASB Statement No. 107,~~ ~~*Disclosures about Fair Value of Financial Instruments*~~~~, and FASB Statement No. 115,~~ ~~*Accounting for Certain Investments in Debt and Equity Securities.*~~

.67~~.70~~ Disclosures in statutory basis financial statements for items or transactions that are accounted for differently under ~~a~~ the statutory basis than under GAAP, but in accordance with the revised Manual, should be ~~the same as~~ the disclosures required by the revised Manual. ~~GAAP that are relevant to the statutory basis of accounting for that item. Such disclosures can be separated into two general categories, which are discussed in paragraphs .71-76 of this Interpretation. The examples pre-~~

~~sented are for illustrative purposes only and are not intended to be all inclusive.~~

.68~~.71~~ ~~Specific disclosures are stated in GAAP literature for the accounting method used in the statutory basis financial statements, even though the item would be accounted for differently under GAAP. In such instances, the applicable GAAP disclosures should be made in addition to those disclosures considered necessary upon review of the Annual Statement instructions.~~ If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual for that item or transaction, but it is in accordance with GAAP or superseded GAAP, the disclosures in statutory basis financial statements for that item or transaction should be the applicable GAAP disclosures for the GAAP or superseded GAAP. If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual, GAAP or superseded GAAP, sufficient relevant disclosures should be made.

~~.72 For example, certain leases entered into by a lessee insurance enterprise that would be accounted for as capital leases under GAAP are accounted for as operating leases by insurance enterprises in their statutory basis financial statements. In such instances, the applicable disclosures for operating leases required by FASB Statement No. 13, *Accounting for Leases*, should be made in the statutory basis financial statements.~~

~~.73 Another example is reinsurance transactions. Certain reinsurance contracts are permitted to be accounted for as reinsurance transactions in statutory basis financial statements but would be accounted for as financing transactions under GAAP. In such instances, the applicable disclosures for the contracts accounted for as reinsurance transactions that are required by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, should be made in statutory basis financial statements.~~

~~.74 Specific disclosures are not stated in current GAAP literature for the accounting method used in the statutory basis financial statements. If statutory accounting principles (SAP) permit insurance enterprises to use an accounting method that has been superseded under~~

~~GAAP literature, disclosures that were required under the superseded GAAP literature should be made.~~

~~.75 For example, some insurance companies are permitted to account for pensions in their statutory basis financial statements using the same method as required under APB Opinion No. 8, *Accounting for the Cost of Pension Plans*, which was amended by FASB Statement No. 36, *Disclosure of Pension Information*. (APB Opinion No. 8 and FASB Statement No. 36 were superseded by FASB Statement No. 87, *Employers' Accounting for Pensions* [AC section P16], for fiscal years that began after December 15, 1986.) In addition to disclosing the accounting policy for pensions, insurance companies should make the disclosures contained in APB Opinion No. 8 and FASB Statement No. 36 in their statutory basis financial statements. If a company is accounting for pensions using another method of measurement, such as tax, it should make informative disclosures, at a minimum, such as type of benefit formula, funding policy, fair value of plan assets, and amount of pension costs.~~

~~.76 A final example is deferred acquisition costs (DAC). Acquisition costs are expensed when paid under SAP and are capitalized and amortized under GAAP. FASB Statement No. 60 [AC section In6] requires certain disclosures about DAC—the nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period. Because DAC are not capitalized under SAP, such disclosures, other than a description of the accounting policy used, are unapplicable.~~

.69~~.77~~ When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (*a*) related party transactions, (*b*) restrictions on assets and owners' equity, (*c*) subsequent events, and (*d*) uncertainties. Other matters should be disclosed if such disclosures are necessary to keep the financial statements from being misleading.

.70 *Question*—There may also be instances in which state requirements have not been revised to reflect a new GAAP disclosure requirement. What are the disclosure requirements in those situations?

.71 *Interpretation*—Until state requirements are determined, the statutory basis financial statements should include disclosures required by new GAAP requirements that are relevant and significant to the statutory basis of accounting, pending acceptance or rejection for inclusion in the revised Manual.

Effective Date and Transition

14. This SOP is effective for annual financial statements for fiscal years ending on or after December 15, 2001, complete sets of interim financial statements for periods beginning on or after that date, and audits of those financial statements. Disclosures of information required by the amendment of SOP 94-5, in paragraph 8, item 8, and paragraph 9, item A-2 of this SOP, should be included for each fiscal year for which a balance sheet is presented. Retroactive application is not permitted. If comparative financial statements are presented for fiscal years ending before December 15, 2001, the disclosure provisions of SOP 94-5, as effective prior to this SOP, apply to permitted statutory accounting practices by the domiciliary state regulatory authority.

Accounting Standards Executive Committee (2000–2001)

NAIC Task Force

AICPA Staff

The Accounting Standards Executive Committee gratefully acknowledges the contributions of Keith Bell, Jean Connolly, David Jahnke, Susan Jones, Elaine M. Lehnert, Ed Metzger, Richard Poniatowski, and Margaret C. Spencer.

014932