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Summary: It is expected that by the end of October 1997, the final status of the NAIC Codification process will be close to completion. This multiyear project is designed to define all statutory accounting principles so that there is a uniform set of rules. The panelists describe changes from current accounting practices and identify those issues that directly impact actuaries. Where the project will likely go from this point is addressed.

Mr. Henry W. Siegel: We're privileged to have two very knowledgeable guest speakers. We have Steve Johnson of the Pennsylvania Insurance Department. Many of you may know Steve from his day job, but recently he has been a member of the Codification Working Group of the NAIC and has been instrumental in formulating many of the codification accounting principle papers that we're going to be talking about. Matt Adams of Price Waterhouse has also been following codification very closely, and he is going to talk about the accountant's viewpoint on codification. It has been difficult for many of us who have been working for a long time on codification to figure out the accountant's viewpoint.

Mr. Stephen J. Johnson: I'll discuss everything you always wanted to know about codification but were afraid to ask. It's an interesting comment because a lot of people have been afraid to ask. They thought codification was something the NAIC

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was fooling around with and that it is going to be years before anything happens with this codification project. They didn't really even know anything about it because it was so far down the road. Well, it's here, and that's why Henry thought it'd be a good topic. He recruited me to be one of the members of the working group, so I can understand this animal that's quickly developing and is going to significantly change how financial statements are prepared on a statutory accounting basis as compared with where they are today. You actuaries should know that because you're usually an integral part of the preparation of the financial statements in any company.

I also want you to understand the history. I'm going to talk a little bit of the history and how this project developed. I'll kind of give you an overview of where I think it is today. It changes by the minute.

Henry and Matt are going to get into a little more detail about some of the actual issue papers and *Statements of Standard Accounting Practice (SSAPs)*. I'm here to keep them honest about what they say about each of the *SSAPs*.

Henry has been a very good advocate on the life side of this codification project. He attended all the open meetings and is not afraid to get up and tell the working group what he thinks. He made some very bold statements, but I think he's a very good advocate for at least the actuaries on the life side.

How did this whole project get started? Let's discuss a little bit of the history because, again, it's important to always know where you came from to know where you're going with codification. Back in 1990, the NAIC produced the solvency agenda. This is the great, big agenda that the NAIC put together to counter Representative John D. Dingell's (D-MI) failed promises, showing the weaknesses in state solvency regulation. The NAIC took a very aggressive program and put an agenda together to improve the solvency surveillance of the insurance industry. Part of that agenda included the accreditation program. It had an item about the update and codification of the NAIC's accounting practices and procedures manuals which is the last item on the solvency agenda that hasn't been completed. That's why this whole project got started. Obviously, when the NAIC was looking at where the holes were in its solvency surveillance, one was the lack of guidance in how to prepare a statutory accounting statement.

The *Accounting Practice and Procedures Manual* gave very little guidance. Many times it said you should go to your domiciliary state to find out what to do. The NAIC recognized that was a problem in solvency surveillance. There was no good source of accounting guidance on how to prepare a statutory financial statement

that the regulatory agency could use in monitoring the financial condition of the industry.

The NAIC started out in 1990 with this project. During the period from 1990 to 1993, we had early codification which, as an organization, is our first try at it. That was going in with two separate working groups—one on the life side and one on the property and casualty side—to try to write our current *Accounting Practices and Procedures Manual*. It just wasn't working. We didn't get very far. In fact, in those three years, they have only amended one or two chapters of the book. So, in 1993, the NAIC started recognizing that the project wasn't going anywhere. Then some pressure came from the AICPA. The AICPA issued a white paper in 1993 to the NAIC saying that this codification project is not really working. The AICPA said that the NAIC should consider doing GAAP with exceptions. The FASB and the AICPA should allow GAAP to be the main standard setter, then just determine what exceptions are needed from that to produce a statutory financial statement.

The NAIC took a look at that white paper and decided it wanted to be in control of its own destiny and how statutory statements are to be prepared. As an organization, it wanted to keep that in-house and not give it to the FASB and the AICPA. That is what made people recognize that the current process wasn't working and it something needed to be done. The NAIC needed to reengineer how this whole codification project was going to work. In 1994, the project was reorganized to what it is currently, and we'll talk about the reorganization as we go along. We'll discuss how the process has worked from 1994 to the present.

Certainly, one of the things that also has spurred on the whole process is how the AICPA in 1995 issued a statement of position on how it will opine on statutory financial statements. What it said was that, in the future, it was no longer going to opine on permitted and proscribed. It wanted the NAIC to develop a codified set of rules on how statutory accounting financial statements are to be prepared so it can audit off them. It said that it will continue to opine on permitted and proscribed, but it will wait until the NAIC finishes its project. This certainly spurred the NAIC to move much quicker with the codification project.

Why was it needed to begin with? Wasn't everything just peachy keen with permit and proscribe? Wasn't everybody having fun preparing them with few problems? What was the problem? Why did the regulators think they needed it? There are many other parties like the insurers and the CPA firms that really have a stake in this. First of all, regulators need it because there were no comprehensive guides. Has anyone really looked through these books? The number of holes are incredible. There is so much lack of guidance in there that there was no comprehensive basis of statutory accounting.

There is no comparability between statutory financial statement plans. A quality financial reporting system has to have comparability or what good are the numbers on any financial statement? The only thing that gives financial statements the quality they have is when you have comparability between one entity and another, plus if you are able to accumulate all that information and get information for a whole industry prepared on the same basis. We didn't have that. We only had this permitted and proscribed. Many of us didn't even know what the permitted practices were. Many states were giving out permitted practices very easily. Others were tough. Nobody knew what they were when they looked at a blank. If you look a blank, you wouldn't be able to tell me what the permitted practices were. Even the proscribed went to each individual state law. Do you know every state law and what items in that law are financial statement items that go into the preparation of the statutory accounting statement? No. So, if you have no idea how the financial statements are presented, how can you determine comparability? You can't. It was a problem for us and it was a problem for regulators when we tried to compare different companies, even within our own domiciliary state. If I gave a permitted practice out to one company and not another, there goes comparability, even within my own domiciliary industry.

With every good financial reporting system you have to have a foundation. We had no foundation in statutory accounting. We had no conceptual framework which is the foundation upon which everything is built. GAAP certainly has it, but statutory accounting didn't have any type of framework upon which it had laid a foundation to build all the individual accounting principles. That's a problem in a proper financial reporting system. We needed that, but we didn't have it.

Insurers need codification. The current manuals were difficult to use. There was just so much lack of guidance. Insurers had a difficult time deciding how to present this in their financial statements. Do I defer to GAAP? Do I try to get it permitted? Do I even call the insurance department and open up that can of worms?

There were different rules from state to state. Many insurers are creating blanks for each of the different states they're licensed in under those proscribed methods. You're creating annual statement blanks for multi-states based upon different methods of accounting. This is difficult for insurers. Why do CPAs think it's necessary? They certainly have a stake in this. They've always found it difficult to define statutory accounting. Did you ever know any CPA firm that went through all the laws (in both the statute and the regulations of the state of domicile that company is in) that had to do with the preparation of the financial statements for statutory accounting? There are none. They had difficulty with proscribed versus permitted. It is very difficult.

Let's discuss litigation. Many regulators are suing because of the insolvencies of the 1980s and early 1990s. Many accounting firms are being sued by regulators, and one of the problems that has created this is the lack of a comprehensive guidance. This lack of guidance has allowed these gray areas on how financial statements should be prepared and that leads to litigation. A CPA firm wants something that is comprehensive. The firms want to be able to determine whether the company followed the rules when they audit the financial statement? There is less chance of litigation if you have that type of system in place. We don't have that today. That's a little bit of background on where we are.

Let's discuss the development of the project. What is codification? It is putting all the guidance an insurance company needs to prepare its statutory financial statement and all the guidance your CPA firm needs to determine whether you've complied with that guidance into a single source so it can issue an audit opinion. There is a two-volume set of notebooks I'll talk about.

It's going to address areas where there is no current guide. One of the problems has been lack of comprehensiveness. This project is being developed to plug all the holes out there on how things should be reported, and we're going to attempt to conform to a statement of concepts. The first step in this project that I'll get to is the development of a statement of concepts, which is our foundation.

We didn't have a foundation, as I talked about. We had to develop the concept of a statement that's prepared under statutory accounting principles. That's the first thing this organization did. In September 1994, it produced and approved a *Statement of Statutory Accounting Principles Statement of Concepts*. It talks about three, definitive concepts that are the framework, the foundation, for everything we do when we actually build the house which is our individual statements of the statutory accounting principles. They are conservatism, consistency, and recognition. If you do nothing else with this codification project, you should pick up what is called the "Preamble to the Codification Project." It's a paper that the working group put together that outlines all I'm talking about with the history and where it's coming from. It includes the statement of concepts. If you do nothing else, at least take a look at the preamble. All the papers that we will discuss are on the NAIC's Web site, naic.org. Read the preamble to understand what's going on and what you're in for going forward in the future. The preamble is critical since it also has the statement of concepts in it. We have amended the statement of concepts from September 1994 to present. After we went through this whole process for three years, we found that the statement of concepts was a bit flawed. We went back and actually made some amendments to the statement of concepts that are out on the Web site in the preamble. We now have a foundation to build on.

It's going to create a comprehensive guide to statutory accounting. We can't just rest on our laurels. One of the problems in the past with statutory accounting was that we didn't have a good infrastructure at the NAIC like they do with the FASB and with the AICPA to currently monitor the industry to determine what needs to be changed, what needs to be updated, and what needs to be amended in our papers. One of our objectives is to create a process going forward to continue to monitor financial reporting of this industry on a statutory accounting basis to determine whether there needs to be any changes to the papers. Should we add new papers or give new guidance? We want that infrastructure to be in place going forward so we don't get to where we were in the past. We didn't really have a good structure to continue to monitor the industry and make changes to those as we go forward. Then you'll find yourself where we were in 1990, with just inadequate guidance because it wasn't kept current.

What is the conceptual basis that we used in the statement of concepts? It basically begins with a GAAP framework. We looked at every piece of GAAP literature, which I believe is on the Internet. One appendix to this final project will be a cross-reference guide to every piece of GAAP literature and whether we incorporated any part of that GAAP literature into statutory accounting principles. If we did the whole thing, it will reference the specific *SSAPs* that a portion of or the whole GAAP guidance is incorporated into statutory guidance. This cross-reference took a lot of work on the part of the NAIC staff. They went through all the GAAP literature to make sure we looked at every piece of it. We made a definitive determination about whether we wanted that type of guidance in statutory accounting.

It outlines the regulatory objectives. One of the things you'll notice in the statement of concepts is a discussion of the objectives of statutory accounting principles in our concept statement. It gives a foundation for evaluation of alternatives in accounting principles. What I'll just say on that final note is that when the working group started the process, it decided just philosophically, that no matter what the statement of concept said, we didn't want a lot of alternatives. Many of us felt that one of the problems in GAAP is that there are just too many alternatives that GAAP allows out for financial reporting. We tried to reduce as much as possible any type of alternative accounting treatment within each of the *SSAPs*. They are not many, but there are a few.

How does this thing work logistically? How did we get to where we are today? When we reorganized in 1994, the NAIC created one working group to do statutory accounting principles. It is the Codification of Statutory Accounting Principles Working Group. That working group was given money to go out and hire a consultant that first started out as Price Waterhouse, then became Deloitte & Touche. Deloitte probably did 80–90% of the work, but we were given the money to go out and hire a consulting firm to help us in the process of developing the issue

papers that I'll get into. The final guidance was the *Statements of Statutory Accounting Principles*. The NAIC was allowed to hire two staff people dedicated to work with the consultant in the working group.

Then we had people like Henry Siegel on our Interested Parties Group. Other regulators didn't get involved, but we had many interested parties outside of regulators. It didn't seem like other regulators were really bothering with this project, but there were many interested parties involved. Keith Bell led the property and casualty side of the Interested Parties Group. Another person from Prudential led the life side of the Interested Parties Group. They had a ton of companies behind them, and they were like the filter and there was other people involved. Henry was the AAA representative. We had other interested parties coming before us to comment on each of the issue papers first and then the SSAPs.

There was a group of 11 regulators behind this that has been meeting regularly, (at least once a month for the last three years) on this project. It's headed up by Norris Clark who was the chairperson of the working group. I think we had 11 or 12 different representatives just from New York. We had an outstanding group of regulators from 11 states: California, Delaware, Illinois, New Hampshire, New York, North Carolina, Ohio, Pennsylvania, Texas, Virginia, and Wisconsin. There were some very intelligent people that have been through the wars and understand where the holes were in the prior statutory accounting principles that needed to be closed up. These are people that went through a lot of insolvencies when you look at these states. I don't have to mention the names of the insolvencies in those states over the last ten years.

The process started with an issue paper. The issue papers which are going to be an appendix to the final codification manual really are an accumulation of our research on a topic. The consultant would start the research and actually draft up the initial paper. It would be previewed by the NAIC staff, and then presented to the working group. The working group would then analyze it, decide whether it wanted to keep those positions or change them. There were a lot of changes within the issue paper before they got exposed for comment. From those comments we revised and finalized the issue paper. This is our research document that's going to be part of the permanent record of the codification because it's going to be an appendix.

The issue papers contained a summary of the issue, whatever it was, and the other speakers will talk about the definitive guidance. It had a summary conclusion. It had a discussion section that discussed all the alternatives. It laid out the relevant current statutory accounting principles, if there were any, as well as GAAP guidance in that area and any other sources of information, sometimes using certain states' laws and regulations that might have had some guidance in a specific area. I would

personally review all the *SSAP* and GAAP out there, and other sources of information. I would read the discussion and then get to the summary conclusion and determine whether I believed in it or not.

We already talked about the problem with the current format. What the working group did was create the issue papers which is our research document. From there it decided to extract only the specific accounting guidance and extract that from the issue paper into an *SSAP* where the definitive guidance is housed. The *SSAPs* take the format of a financial accounting standard (FAS). We decided to go that route because there are some logistics to take into consideration. The FAS is a historical record of the accounting literature at any point in time. You can go back in and graze an area out in the FASB. It tells you that was superseded on a specific date, and you can figure out before that date what the guidance was. The guidance is never lost.

One of the problems we had in the old method of statutory accounting was the old guidance used to get thrown away. There was no historical record of changes in statutory accounting. We're taking the FASB format so that from now on, starting at the very beginning, you'll be able to go back and figure out what the guidance was 30 years before in that particular area. Now we are going to keep a historical record like the FASB does going forward. They will be housed in the *SSAPs*. That's where the true accounting guidance is, and these will be the documents that will be kept around in perpetuity. If there are changes, they will be so described in that issue paper and will be forwarded to you in a new issue paper.

The other panelists will go over some of what we'll call the initial series of *SSAPs*. This will be the final work product that the working group has put together. I believe that there are about 70–80 in the initial series of *SSAPs*. The numbering system is kind of strange. It starts out at two, and it goes to 97 or 98. There are holes in it, and that's because we kind of laid them out in numerical order at the very beginning. We then found out as we went along that we could consolidate some and really didn't need others that we thought we did. This created holes in the numbering system. We're not sure if we're going to go back and change that now because everybody who has worked with this project knows, for instance, what *SSAP* 35 is. If we change 35 to 30, it's going to mess many people up. So we're not sure if we're going to go back and actually put them in numerical order or leave the holes in.

Before I give you the current status, I'd like to tell you this will be updated. As I said one of the most important things is that we must not just sit on our laurels. We must constantly have an infrastructure in place. There is a position paper on the Internet that the working group put together. It delineates the process of going

forward to continue to keep statutory accounting principles updated and current. The Accounting Practices and Procedures Task Force will have that responsibility. They will likely create a permanent statutory accounting principles working group (we don't know what we're going to name it yet) that will have the support of the two NAIC staff people who will always monitor what's going on in the financial world, including new GAAP pronouncements, and whether there's anything coming in from the industry itself telling us that they need guidance.

We are also planning in that position paper to recommend keeping the Emerging Issues Working Group together, which currently is in place. We've defined what this group is supposed to look at. This group is really only supposed to interpret what's out there. It's not supposed to create new guidance at all. It's only supposed to interpret specific factual questions concerning an *SSAP*, and this same type of entity exists in the FASB world.

The research and drafting will be done by the working group. We'll have an issue paper where all the research will be done on an issue. Those will most likely be drafted by the two NAIC staff people, reviewed by the working group, exposed during a comment period, put into an *SSAP*, and exposed once again during that comment period until we get to where the final guides would be approved by the NAIC up through its committee structure at the plenary. We hope that will alleviate any of the problems of the past.

Where are we today? What is the current status? The final guidance, a two-volume set of books, was exposed on April 15, 1997. We held public hearings in June, July, and August. These were six full days of hearings on our final product. We have now made revisions based upon the comments and from the public hearings. All the changes that the working group made were completed by the fall meeting. On October 8, 1997, all the changes were put out for the public on the Internet. The public now has until October 29, 1997 to comment on any of the changes that were made to any of the papers.

At the September 1997 meeting of the NAIC in Washington, the working group voted the project out, even though we didn't publish all the changes that were made from the public hearing. The working group felt that could be handled at the committee structure at a higher level. It was moved and approved at the Accounting Practices and Procedures Task Force, and moved up to the Financial Condition (EX-4) Subcommittee. That group decided to wait and see what comments were received between October 8 and October 29. It will then review those comments and determine what to do with the project at a later date. The EX-4 Subcommittee is now going to meet on November 20 in Kansas City to review the comments with input from the working group members because the working group members have

been invited to sit on EX-4 as advisers to the subcommittee to review all the comments.

The life reinsurance paper was allowed to be opened by the chairperson for substantive comments at the EX-4 meeting in Washington DC. This chairperson (the commissioner of Wisconsin) said she would also take substantive comments on Issue Paper 74. This raises the issue of the question and answer section, which is a big beef that many life actuaries and company actuaries have in the life reinsurance area. We adopted the Q&A that was developed by the Life Actuarial Task Force that was never totally approved by the whole organization. My understanding is this concept of segregation or segmentation is still an issue with much of the life reinsurance community. That's still open for discussion at the EX-4 meeting in November. The commissioner of Wisconsin said that if any other member of EX-4 wants to open up any paper for substantive comment, he or she may do so. We have heard from our industry on some of the issue papers that they believe should still be open which are Agents' Balances 6, Guarantee Fund Assessments 35, Property and Casualty Reserving, Issue Paper 55. These are the three papers that a portion of our domestic industry who sits on the Interested Parties Group would like to see reopened and may get reopened at EX-4 for substantive comment.

What I'm hoping is that on November 20, 1997 EX-4 will approve the codification so that a executive committee can be held either at the December 1997 meeting or prior to the December meeting of the NAIC whereby then at the December meeting, the NAIC plenary (the whole body of the NAIC) will vote on codification and approve it for an effective date of January 1, 1999.

Mr. Siegel: The next portion of this presentation would have been Keith Bell's (he couldn't be with us), and it's going to deal with the details of what he calls the 10 most significant issue papers. To some extent these issue paper numbers, as Steve said, are like the old joke about the guys in the prison who knew the jokes so well that they had them numbered, and every time you mentioned a number everybody would crack up. We have codes, too, and every time somebody mentions 54 or 35, we have a reaction.

The Interested Parties Group hired Ernst & Young to do a survey of the effects of proposed codification rules on surplus of the interested parties' companies. Based on that survey, Ernst & Young prepared a report that indicated which of the issue papers had the most significant impact on companies' existing surplus. The theory is that once you knew that, you would know where to spend your time in terms of trying to make things change. The first five of these are the treatment of electronic data processing (EDP) software. I'm not going to deal with property and casualty contracts.

Keith Bell knows this stuff inside and out because he was the chairperson of the Interested Parties Group. There are a lot of issue papers that I'm not particularly an expert on. Perhaps one of the other panel members is. If I get to one of these papers, and I don't quite know what to say, I'm going to rely on one of my other panelists. We're talking about a \$3 billion decrease in industry surplus because of the EDP paper. At the same time there are some other papers that have a major plus. The property and casualty paper has a major plus. At the same time there's one paper that's not dealt with at all, and that's the tax paper. The tax paper has a major positive impact on industry surplus.

The total impact on the industry surplus before the effect of the tax paper was expected to be about -\$11 billion. Obviously, the industry was not interested in having its surplus decreased by \$11 billion. This caused a lot of discussion and I think eventually it caused changes in some of the papers to ameliorate these numbers. We will go through these issue papers one by one.

Issue Paper 16 deals with the treatment of EDP equipment and software. Currently, major EDP equipment was an unadmitted asset and operating software was also an unadmitted asset. Under the proposed guidance EDP equipment and operating software are admitted but only subject to a 3% cap of capital to surplus. That is, your admitted asset can't be any greater than 3% of your capital and surplus. I believe this reflects a compromise.

Mr. Johnson: The initial issue paper had all EDP equipment nonadmitted, and, in fact, the number that reflects the impact on industry surplus was based upon the fact that all EDP equipment would be nonadmitted. Based upon that survey, as Henry said, the working group looked at a lot of the issue papers and made some changes. It went from nonadmitted to being admitted, but at a cap of 3%.

Mr. Siegel: So this was a change to bring down the effect of this issue paper, and I'm sure it's a lot less than the \$3 billion that was there, but we don't have a final survey at the moment.

Mr. Johnson: The working group ran on the database what the total amount of EDP equipment was compared to the industry's capital and surplus, and it was around 1.7 and 1.8. So we believe 3% should cover everybody on the whole.

Mr. Siegel: We hope. The next issue paper has to do with guarantee funds, and right now, guarantee fund assessments are recognized when they're incurred. The proposed guidance was to recognize when the assessment is "probable." This does not distinguish between the situation in life and health where the assessments are made retrospectively based on numbers that existed at the time of the insolvency

and the property and casualty basis where the assessment is based on the premium relationships in the year of the assessment. So it became very difficult for property and casualty companies to show this amount before it was actually assessed because they didn't really know what the percentage would be because it was based on premiums in the year that the assessment was made.

Mr. Matthew J. Adams: I just wanted to clarify one thing. The words "when the current assessment was incurred" means when you got the assessment, not so much when you incurred the liability. That's why it still has a negative impact on surplus, and this brings it much closer to how GAAP would treat contingencies.

Mr. Johnson: This is a paper that's still controversial. Two things the working group still points to as one of the factors is, before you book a liability, there has to be reasonable determination of an estimate, and that will be further out from the point of when an insolvency actually occurs because I've never seen any entity file a financial statement with the regulators that shows a negative capital and surplus. It's going to be a later point when the actual insolvency occurs. The industry people keep telling us they think it's going to be sooner than that. One of the gives is the right for premium tax offset.

Mr. Adams: Is the surplus impact lower?

Mr. Siegel: It's probably going to be even lower.

Mr. Adams: It could be by a substantial amount.

Mr. Siegel: Exactly.

The working group was dealing with both property and casualty and life and health companies. One of the things that they did was divide up the health reserves into two papers—Issue Paper 54 dealt with health reserves and Issue Paper 55 which deals with unpaid claims, losses, and loss adjustment expenses. For health insurers who traditionally estimate claim liabilities and claim reserves in one piece, it means that there's separate guidance on the two of them which is in conflict with the minimum reserve model law for accident and health insurance which deals with the things in total. There are a lot of consistency problems between Issue Paper 54 and Issue Paper 55. I think that when we get things done, it will work out and it won't be a problem.

However, there is a problem as far as Issue Paper 55 is concerned. The current guidance is you record a reasonable vision for losses, and according to GAAP guidance when you have a range and no point is any better, you pick the bottom

number of the range. Because statutory accounting has conservatism as one of its principles, the proposed guidance is to record the best estimate of losses. We'll get back to that terminology in a minute. If there's a range of values for which no point is any better, you pick the midpoint.

People got very upset about this midpoint concept. In particular, a lot of health companies hold higher than what I would call expected value reserves. They put margins in their reserves. They were concerned, to this day, that they would be forced to take this out of their reserves. This could have a very unpleasant impact. We negotiated that this midpoint concept only applies in the limited circumstances where you have a range of values, and that is a continuous range of values. There's no point in that range that's any better than any other. If you have a range that looks like a normal curve where you think the outliers are less profitable, then you don't have to pick the midpoint of the range. You pick management's best estimate. A best estimate is not defined. It does not necessarily mean the point where it's 50% in one direction and 50% in the other direction or that it's going to be better or worse. Whatever you think best estimate means in terms of most likely or whatever doesn't necessarily mean it is the best estimate. It could just be your best estimate. We're taking into account the fact that there's a lot of variability, and we think it's best for the company if we hold a slightly higher reserve. The best estimate is not defined, and there's not going to be a definition put in either.

Mr. Johnson: No, there's not. Our casualty actuarial friends are very upset over this paper because they believe, first of all, best estimate has never been used in the casualty side of the house and that reasonable provision does have some history to it. The working group felt that we've seen too many cases on the casualty side where the reasonable provision is a range that's fairly broad, and companies take the low end of a very broad range that the casualty actuary said is reasonable. If you put a best estimate into the accounting literature, we don't believe you can take such low ends of the range and book them as your held reserves and be in compliance with codification. The whole point was that we wanted to raise the bar a bit for companies that were using the low end of a reasonable range when the spectrum of the reasonable range that the casualty actuary gave was fairly broad. We wanted to get away from companies not being responsible, in my opinion, and picking the very low point of a range. If they were in the upper point, in many cases, they would be insolvent. I'm not talking about the huge property and casualty companies. As regulators, we have to deal with the lowest common denominator in the industry, which makes it difficult for the big boys to understand what we have to do. Nonetheless, this was the concept, and I know my casualty actuary friends have been gnawing in my ear now for a while, and they were just in the other day to gnaw on the commissioner's ear on this whole issue of a best estimate compared to a reasonable provision.

Mr. Siegel: It's interesting because I've been having the health actuaries gnawing on my ear about the fact that this would lower the bar for them, so you have different perspectives from different industries.

Mr. Adams: One other quick comment regarding accounting standards with respect to estimating contingent liabilities (which this would fall under). The accounting world would say that you record your best estimate. That is acceptable accounting terminology. I know casualty actuaries that I've spoken with over many years have that trouble as well. Accruing the midpoint of a range is somewhat arbitrary, and there's no good answer to this issue, although GAAP had one way to mitigate this problem of arbitrariness, and that was to require disclosure of what the range is when no best estimate can be reached and when some point within a range, be it the minimum or the maximum, is recorded. I don't think that was included in the codification, but I thought that was one way to mitigate it. Actually that could still be a mitigating factor because it's likely that the GAAP disclosure requirements will still apply to codified statutory accounting. In a way you get the mix of the two. You get a little better result than just looking at this statement of position in and of itself without considering that.

Mr. Siegel: Issue Papers 6 and 10 have to do with amounts due. Apparently the issue is that there's a departure from guidance where everything is aged from the date that a policy starts. I don't understand this issue, but there is an issue. If you're concerned with this issue, you need to talk to your accountants about it.

Mr. Johnson: The issue is that many people age their agent's balances based upon when the agent is billed. This issue paper now says it's the policy effective date. It is when the 90 days runs that you can allow the agent's balance as an admitted asset on the company's books. After 90 days from the effective date of the policy, the agent's balance is now nonadmitted. That can be a fair disparity, especially for my casualty friends who said that when they're doing a big Fortune 500 account, it doesn't work that way. They'll never be able to meet the 90-day provision from the effective date. They've requested the working group to look at the ability for companies to allow those balances that are 90 days and over at the end of December 31, that are collected by February 15 in the subsequent period, and those balances would be allowed to also be admitted. That's one of the things they're apparently going to present at EX-4. They presented that concept once, and the working group turned it down. They're going to try to present it to EX-4.

Mr. Siegel: Issue Paper 5 has to do with the definition of liabilities. They're talking about a midpoint of a range, when there's no point that's any better. This is a highly technical accounting item.

Mr. Johnson: The controversy was this is where the midpoint concept actually lies in the *SSAPs*. I think we've cured a lot of that, as Henry said. This is an interesting paper because current statutory accounting had no concept of a contingent liability. This is probably one of the most important papers to come out of codification. It at least allows some guidance on when a liability actually gets recognized on the books and when it needs to be disclosed. We didn't have any of that type of guidance. If we do nothing with codification, then having *SSAP* Number 5 is the biggest tool ever given to a regulator for financial reporting.

Mr. Siegel: The next one, Issue Paper Number 46, has a major effect. Right now, many companies are accounting for subsidiary stock at its most recent trading price. The proposed guidance basically said you have to keep it at book initially, and then it was said that you had to pick a trading price. You can't change it without the approval of the commissioner. Right now I think it depends on how much you control. For certain percentages you can write it at market, and for other percentages, you take a haircut on market.

Mr. Johnson: There's a chart in Issue Paper 46. It depends on how much the insurer owns of the subsidiary. There's a sliding scale haircut that's taken based upon the different levels of ownership that an insurer has of a subsidiary that's publicly traded.

Mr. Siegel: If you own over 85%, you hold it at GAAP equity. Otherwise you hold it at market value with a particular discount.

A fun one that is near and dear to all our hearts is Issue Paper 83. This is on income taxes. As you all know, GAAP allows you to hold deferred tax assets and liabilities and has ever since GAAP was around. For statutory accounting, you always held your current year's tax provision by and large. Under the new GAAP Statutory 83, you are allowed to hold deferred tax assets and deferred tax liabilities. You can hold deferred tax assets and deferred tax liabilities subject to certain limitations. You have to have a written allocation for intercompany transactions, and your estimated interim period taxes can be based on this issue paper as well. The big news is you can hold deferred tax assets and deferred tax liabilities up to certain levels which can have a major impact on your surplus depending on whether you're a deferred tax liability or a deferred tax asset type of company. Most of us have deferred tax asset because of the deferred acquisition cost tax accounting. However, some people may find it goes the other way. This has a major swing for a number of companies. You need to take a careful look at it.

Mr. Johnson: We have been told that this is probably going to be the most complex issue in *SSAP* for the industry to implement from a logistics standpoint. The

feedback we've gotten is that most of the industry will be able to recognize a deferred tax asset, and it will boost surplus. If there's a surplus to gain, somebody will do the calculation and figure it all out.

Mr. Siegel: There's a three-year phase-in of this provision. You pick the deferred tax assets which are the sum of the federal income tax paid in prior years recovered through loss carryforwards for existing differences that reverse by the end of the next calendar year and the lesser of the deferred tax assets expected to be realized within one year, and 10% of statutory capital and surplus. So you have to look at when your deferred tax assets are expected to reverse. You can net them against deferred tax liabilities as well, and then you're allowed to hold a little bit extra. If you really need more information on this, it is a good thing to talk to your friendly neighborhood accountant about.

Mr. Adams: I'm a partner in the audit and business advisory services practice at Price Waterhouse where I have been for a little over 12 years. I have devoted substantially all of my time to the insurance industry and many of our most important insurance clients. The most noteworthy are CIGNA and Prudential. In fact, Steve and I spent many years in Pennsylvania working out some issues with CIGNA that some of you may have read about from time to time. I had spent more than 11 years in Philadelphia and recently relocated to New York.

Steve and Henry gave you a great overview. Henry has asked me to give you the auditor's viewpoint and how it might affect our audit reports on financial statements. Why do we need codification? Steve gave you his views on the subject, and I just wanted to add a few things. It was widely believed that an independent audit requirement that came about in 1991 prompted this new focus on statutory accounting and created a lot of the initial furor over statutory accounting, and that's partially true. I think the rule was established for all insurers for the first time. Prior to that maybe Minnesota and one or two other states had an audit rule in place as early as 1987. A few states had it and a few didn't. But this nationwide rule really added focus on the quality of statutory accounting.

The normal financial statement auditing standards are similar in many ways to actuarial standards in defining how auditors approach their audits and in defining the frame of reference that's required for auditors to perform their work. That is based on the assumption that there's a comprehensive framework of accounting standards upon which we'll base our work and issue our reports. The best example of that is GAAP. Another example of that is tax basis accounting or the cash basis. As Steve mentioned, statutory accounting was more a state-by-state approach, although there are probably 15 or 20 states that had a more unified approach because it was based on the NAIC accounting manual. The underlying structure of

statutory accounting really made it tough on accountants and regulators to compare financial statements of companies in different states. In addition, I think a lesser known but important fact is that there are many other users of the financials besides insurance company management and regulators, namely banks, investors, and rating agencies. We accountants and auditors were concerned that our being associated with statutory accounting principles that weren't comprehensive would be misleading to these other parties that may not have known about or appreciated the extent of the differences.

I just want to make a few comments on this notion of proscribed and permitted practices in terms of background just to illustrate that there was some common element of uniformity to the statutory accounting world. It wasn't complete chaos that allowed us some basis to perform audits and issue opinions. The NAIC developed model laws and regulations governing accounting practices. States have the flexibility to adopt the model laws or otherwise prescribe specific accounting practices, depending on what they believed to be in the best interest of their constituents. This approach was very different from GAAP, which accountants and auditors are generally more comfortable with.

GAAP is a relatively widely accepted body of accounting knowledge, and it changed almost constantly as businesses and economic conditions changed. There weren't changes that were made specifically to an industry or a specific state. So even though it wasn't always the greatest, it was at least comprehensive. The NAIC accreditation process did provide some incentive for states to approach an increased level of uniformity, but this didn't always work as well as it could have or should have because certain states didn't buy into the accreditation program. New York is a good example of that.

Despite the improvements that were made, there really was no national standard, and there were some pretty important differences by state. New York, for example, did not allow any goodwill to be recorded. Most states allowed an amount equal to 10% of surplus to be recorded. Massachusetts allowed excess assets in a pension plan to be recognized as an asset where other states didn't. We found that permitted practices, as well as proscribed practices, resulted in some widely varying decisions on accounting and reporting issues. I think it's pretty obvious why auditors don't like *SSAP*. It doesn't fit well within our reporting standards and our obligations as auditors because it's really not a comprehensive and consistent frame of reference. Our frame of reference and our auditing standards have generally been built on GAAP accounting. So statutory accounting was an add-on that occurred much later. GAAP, although it's not always liked, is recognized as being uniform and at least something that everyone has a chance to understand, even though they do not always understand it. We thought statutory accounting allows

for far too much flexibility and renders many insurers' results to be not comparable and, in turn, auditors' reports would be less meaningful, and that was a problem for us.

I wasn't going to mention litigation, but since Steve did, I will too. That was a big concern of ours. We were being held accountable for failures in connection with audits based on statutory accounting standards which we didn't like, but we didn't do enough about changing them earlier in the game. With the late 1980s and early 1990s, we took more of a stand, and we're trying to drive that along with the regulators.

My view of what the industry thinks based on my interaction with my clients, actuaries, and other interested parties outside of regulators is that they've just had a hard time wrestling with and accepting codification. Steve, I do remember sitting in some working group meetings in 1990 or 1991 and reading edited versions of the accounting standards. I couldn't believe that it really didn't move more quickly. It was pretty frustrating. I think most in the industry believe that even today it's unreasonable to maintain three bases of accounting which is a direction we may be heading: GAAP, state of domicile SSAP and codified SSAP. I think companies are really wrestling with the need to meet the expectations of individual state regulators because that's the way things work today. The regulators have a lot of control and authority, and should over what insurers do in specific states. It becomes difficult when it starts affecting auditors, rating agencies, and others. Above all, I think consensus has been so hard to reach in this, but I think we're getting close.

Let me make a couple of additional comments on the maintenance of statutory accounting practices, in addition to what Steve said. I happen to think completing the codification project may be the easy part. Keeping it current and making changes to reflect future business conditions will be very difficult. It's very difficult in the GAAP world. Even if you're not interested in the GAAP accounting world, you may have read how Congress has gotten involved in establishing accounting standards over stock compensation and, more recently, derivatives. It's an extremely difficult process. Imagine Congress getting involved in setting statutory accounting standards. While this codification process has been very difficult, the ongoing future process will be equally difficult.

I think the current plan is to have the Emerging Accounting Issues Work Group and the Accounting Practices and Procedures Task Force be the updating bodies and the representatives from the NAIC. We can also use CPA firms and other interested parties. I think the so-called interested parties' comment letter which was issued October 29, 1997 will include a recommendation that a more formal advisory

board be created. It would include official members from CPA firms and other interested parties, in addition to the NAIC groups. We'll see where that goes.

Mr. Siegel: I did notice the letter didn't mention actuaries.

Mr. Adams: So what is the auditor really concerned about? Auditors don't like—and you may not believe this—to issue adverse or qualified opinions. I don't think insurers like to receive them either, and regulators probably do not like to see them, but this is bound to continue for the foreseeable future, at least in a situation where we issue what we call general distribution reports. These are reports that can be issued by insurers to anyone—to you, to regulators, to banks, to rating agencies, to investors, or to potential buyers. For limited distribution reports, those that would normally go to regulators, the auditors would like statutory accounting practices to be considered what we call another comprehensive basis of accounting (ACBOA) other than GAAP. We think that our conclusion that codified *SSAP* is an ACBOA will allow us to issue clean opinions on a limited distribution basis, and that's really what we'd like to see happen. It's highly unlikely that a state of domicile *SSAP* will be considered an ACBOA for the reasons mentioned earlier. Codification, if it's not completed and concluded in a real tight manner with a good structure for ongoing maintenance, may also not be considered to be ACBOA, which could be problematic.

The Insurance Companies Committee of the AICPA will be making a recommendation to the Auditing Standards Board, our governing body, as to whether it considers codification to be comprehensive or not based on its definitions of what it means to be comprehensive. The Auditing Standards Board will reconsider its reporting standards based on this recommendation and the ultimate outcome of codification. If the Auditing Standards Board considers codification to not be an ACBOA, any reference to statutory accounting will be removed from the auditing literature and the auditing and reporting standards. In essence, it would mean there will be no basis for accountants to report on statutory financial statements. I'll get back to what that really means. If it's considered to be ACBOA, it will amend the reporting standards to recognize codified statutory accounting, and we'll be in good shape. There won't be any problems.

I think there are many implications of it not being considered ACBOA. The easiest to describe is that auditors will issue opinions saying that statutory financial statements are not in accordance with GAAP and refer to footnotes in the financials that describe the material differences between the financial statements and what GAAP would require. In other words, that would be a qualified opinion, and the details of the differences would be included in footnotes, in the opinion, or whatever the case may be. That really isn't a good solution or a favorable outcome, but that's the

likely implication if this is not resolved to everyone's satisfaction, including the Auditing Standards Board.

There's one other issue that is not completely clear to me yet. It is, what will CPAs be asked to actually report on? The annual statements are going to be prepared presumably on some standard or state basis of accounting while financial statements, including footnotes which are reported on by auditors, presumably will be prepared on the basis of codified *SSAP*. There could be a difference right there between the audited financial statements and those filed with regulators. I don't know whether that has been completely addressed yet.

Mr. Johnson: You're going to have to prepare your blank under state law, but many of our state laws dictate that you're supposed to follow the NAIC's *Accounting Practices and Procedures Manual* which this codification will be once it's completed. Although many of us say, if there's specific law over the NAIC's *Accounting Practices and Procedures Manual*, look to the specific law in developing your financial statements. Ninety-five percent of us in the industry believe the state law and codification will not be materially off. An example where it may be materially off is in Pennsylvania where we allow medical malpractice writers to discount the reserves, and in codification you cannot. So a medical malpractice writer, if that discount is material, will be allowed to prepare his blank with the discount, but when the auditor comes in he'll say, "That discount is not allowed in codification. It is material." You're going to get a qualified opinion. That's the kind of small population that some regulators and some commissioners have a concern with. They are in compliance with state law, but they are going to get a qualified opinion from an accounting firm on their statutory audit report. That's the kind of situation that's going on within the NAIC currently. A letter was issued by the president of the NAIC to the AICPA Insurance Committee that will be meeting soon on some of these issues. I believe what the president is looking at is a very small population compared to the whole. The state law on which most companies produced a blank and codification are not going to be so materially different that there's going to be a problem. There's a small percentage where it could be.

Mr. Adams: Allow me to just wrap up with my own outlook. As you can tell, it's not completely clear yet, although it's getting a little clearer. I think we're getting close, and most NAIC factions want a national standard similar in nature to GAAP but modified appropriately for the concerns of regulators. The accountants don't disagree with that but just want it to be closer to GAAP in its level of comprehensiveness and maintenance. I think legislators and regulators generally still want to maintain individual state authority about accounting practices, but there needs to be some compromise to bring this to conclusion. Steve just mentioned the president of the NAIC has indicated she wants CPAs to report on both codified *SSAP* and state of

domicile *SSAP*, which may seem practical to her. It seems fairly impractical to me and to insurers to have to go through any additional cost to do that, although, in many cases, there may not be a material difference.

I think continued compromise is going to be necessary to bring this whole matter to its conclusion after a decade worth of work. I guess it looks like the target for implementation is 1999. That looks good. I guess we have to wait and see how the next two months go to make sure that it really happens, and maybe we can have some flexibility through the first quarter meeting of the NAIC to really hammer this out.

Mr. Johnson: We're walking this tightrope that's very critical. We can never forget history, and if you believe you should forget history, you're not in my same philosophical ballpark. One of the items that had the most credibility in Dingell's failed promises report was that many states did not have an audit statute or regulation in place. Nobody was looking at the numbers between examinations. That was a major problem within the regulatory environment. The whole idea of the CPA audit report, which became an accreditation standard that everybody now has, is that somebody's looking at the numbers between examination periods and taking responsibility of those numbers. If we lose that, we go back to Dingell's failed promises report issued in 1988. We're all in that same quagmire of having companies out there reporting to regulators without anybody taking the responsibility of looking over the numbers from an independent viewpoint between examinations. We're back to some of the same problems we had prior to Dingell's report. As regulators in the industry and as the CPAs, we're all walking this tightrope that we don't want to get off of because if we do, there are some big implications of not having this project go forward and not having CPA-issued audit reports between examinations.

Mr. Siegel: What does codification mean to actuaries? First of all, if you want to go look at codification papers, look at paper numbers 50, 51, 52, 54, 55, and 89.

Mr. Johnson: Fifty-nine is another one.

Mr. Siegel: Fifty-nine is credit insurance. You also might want to look at 74 which is the life reinsurance and 83, which is the income tax paper. In most cases, the codification follows the model laws and regulations and actuarial guidelines that had been published by the NAIC. In most cases nobody here is going to have a problem, but if you're doing something that's very different from any of the model laws, including the ones that haven't been passed by your states, you need to find out. The tax change may have an impact on pricing because of the different incurral rate which shows up on your annual statement.

I would suggest that as actuaries we all need to review all the model laws, regulations, and actuarial guidelines against the practices that we're actually following to see if we're likely to have a material difference. If you're higher than the models, you probably don't have a problem. Second, you need to review all the standards of practice of the Actuarial Standards Board that deal with reserving because they are all referenced and included as part of statutory accounting.

Finally, as you probably have deduced, not all accountants are necessarily going to treat these things the same. There are a lot of issues. Consult your friendly neighborhood accountant to find out what he or she is going to do so that you can help explain to him or her why he or she doesn't have to do what he or she is thinking he or she has to do.

Mr. R. Thomas Herget: Does the actuary have to opine on the codified SSAP numbers or just calculate them?

Mr. Siegel: You're on the committee. There's a proposal afoot that says that rather than opining on the reserves, as in your annual statement, you might have to opine on the reserves based on codification. There's no resolution to that issue, and it is something that's inside the actuarial profession rather than inside the codification work group.

From the Floor: Does this have to be passed by each state or is it done once it's through plenary?

Mr. Johnson: What I've been told by staff is that there are 21 states that do have the reference to the NAIC's *Accounting Practices and Procedures Manual*, and once it's adopted by the membership in plenary, it will automatically become law. The 20-some other states and jurisdictions might have to do something with their statute, and they have to do something in regulation. There are 21, including Pennsylvania, that have the reference to the NAIC *Accounting Practices and Procedures Manual*.

From the Floor: I look to the appendices which accompany the 50s, and there is a fairly religious recitation of all the standard valuation laws, except for *Guideline XXX*. I wonder if you could comment on how *Guideline XXX* stayed out or why it stayed out.

Mr. Johnson: *Guideline XXX* does not go into effect until I think 50% or 51% of the states adopt XXX. We did not want to force it when the NAIC was taking the stand waiting for 51% of the states to adopt XXX or when it goes into effect. If that time

comes, I think it will be included in codification, and we will have to go through the process to get included in codification.

Mr. Herget: The effective dates of the appendices are prospective—January 1, 1999 and later. Doesn't that mean we would have uncomparable results from company to company because all existing business stays on the current state basis? We don't have the comparability until about 30–40 years from now.

Mr. Johnson: I would have to go back and look at the appendices on that. I'm not sure if that's true or not.

Mr. Siegel: Tom, I think that's basically right, but policies tend to terminate, and over time, I'm sure it'll be a lot faster than 30 years.

Mr. Daniel Edward Winslow: I think there are a lot of companies, my own included, that are strongly in favor of such an implementation strategy because we have business that has been sold, had a price locked into it with premiums, and we can't change the premiums. Therefore, we're not very happy about changing the reserving bases.

Mr. Siegel: I think that's the reason that it was done on that basis.

From the Floor: There's a deferred tax concept in the interest maintenance reserve (IMR) currently. Is there a transition to this deferred tax asset/liability?

Mr. Johnson: There's a transition in Issue Paper 83 if you created deferred tax liability. You can recognize the deferred tax asset immediately on January 1, 1999 which you would want to do. On the liability side, we have a three-year phase-in period. I think it's a third each year.

From the Floor: So, the IMR is without any kind of tax effect.

Mr. Siegel: The IMR is not changing.

From the Floor: The IMR currently is net of taxes which is effectively a deferred tax asset or liability.

Mr. Siegel: Yes, and it's going to stay that way.

Mr. Johnson: It's going to stay that way.

Mr. Siegel: This does not deal with capital gains taxes at all. That's not changing.

From the Floor: It would appear that there's a bit of a conflict.

Mr. Siegel: I don't think 83 includes capital gains and loss taxes. I think it's elsewhere.