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GAAP / SAP and RRGs—PUT TO BED AT LAST?

By Troy Winch, Director of Captives, Risk Services, LLC

Although perhaps not as blood curdling as the Hatfield and McCoy feud, the battle between GAAP (Generally Accepted Accounting Principles) and SAP (Statutory Accounting Principles) as the accounting methodology of choice for risk retention groups has likely been going on since the federal *Liability Risk Retention Act* (LRRA) was first enacted. As background, SAP is the accounting protocol largely unique to the traditional insurance and insurance regulatory community. It is basically a more conservative accounting basis, which does not allow the deferral of acquisition costs and other expenses typically permitted of companies under GAAP. Captives (and RRGs which are most often formed under captive statutes) generally employ GAAP, a practice which is blessed by virtually every major captive domicile. Non-captive domiciliary regulators, on the other hand, are most comfortable with SAP accounting, complaining it is more difficult for them to fully understand financial statements filed by RRGs using GAAP.

To bridge the gap (or GAAP if you enjoy puns!) between GAAP and SAP, a reconciliation has always been included in Note 1 of the Notes to Financial Statements of the NAIC Annual Statement (AKA: The Yellow Book). However, recently the NAIC has made a push to have the GAAP to SAP reconciliation also be required within the Notes to Financial Statements of each RRG's audited financial statements. This newly proposed NAIC requirement immediately caught the attention and concern of the RRG community and their respective CPA firms, as this change would now require the CPA to effectively conduct audits on both GAAP and SAP financials in order to include the GAAP to SAP reconciliation within a RRG's audited statements. Such a requirement would add most significant compliance costs to an RRG's financial reporting protocol necessitating:

- *Extra time for the RRG, or their captive manager, to prepare SAP financial statements and a SAP based NAIC Annual Statement (which must be completed in order to properly calculate the RRG's deferred tax asset/liability)*
- *Potential additional software costs to the RRG for NAIC Annual Statement software associated with preparing both GAAP and SAP Annual Statements*
- *Likely additional software costs to calculate SAP deferred tax asset/liability, which is a highly complex calculation for which many insurers utilize specialized software*
- *Additional fees by the CPA associated with adding a SAP audit to the already conducted GAAP audit*

These are but some of the costs which would be incurred by RRGs, which in essence would need to compile and reconcile two sets of books in the walk across footnote (known as "Footnote One") as part of a standard annual audit. Obviously, the RRG community, the majority of which file and are regulated on a GAAP basis, were very concerned given these substantial costs and time commitments which would be incurred to comply with this new requirement. A requirement which would ultimately produce very little regulatory value and the results of which would produce zero regulatory consequence.

This train wreck can be averted. The National Risk Retention Association (NRRA), aided immeasurably by captive domicile regulators (Dana Sheppard of the District of Columbia and Dave Provost of Vermont are to be particularly singled out), succeeded in persuading the NAIC Risk Retention Group (E) Task Force to recommend to the NAIC Financial Regulation Standards and Accreditation (F) Committee to eliminate the requirement that a GAAP to SAP reconciliation be audited as part of the standard annual audit. However, the forcefulness of the recommendation by the Task Force to the Committee is still far from clear. Without a clear explanation by the Task Force to the Committee as to the burden and lack of utility in imposing the SAP burden on RRGs, the RRG community and NRRA, which represents it, should be vigilant in monitoring this issue lest domiciliary states via backdoor regulation by the NAIC accreditation process, impose this SAP requirement on RRGs. As a member of the NRRA Board of Directors, I appreciate that the Association can be at its effective best engaging in these types of "under the radar" but absolutely vital regulatory efforts on behalf of its RRG members.

At this point, the RRG industry does feel a sense of accomplishment with the results it has achieved in persuading the NAIC Risk Retention Group (E) Task Force to recommend to the NAIC Regulation Standards and

Accreditation (F) Committee to eliminate the requirement that a GAAP to SAP reconciliation be audited as part of the standard annual audit. However there are still additional NAIC committee hurdles to clear yet before this issue is completely put to bed. Ideally those hurdles can be cleared and this requirement goes away entirely. If this does not happen then RRGs may be subject to the additional time and expense burden of compliance if they cannot secure waivers from the domiciliary regulators on a one off basis.

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